AT&T

"We have taken steps to establish AT&T as a major international competitor."

C. L. BROWN

1985 Annual Report

American Telephone and Telegraph Company

1986 Annual Meeting

The 101st Annual Meeting of AT&T shareowners will be held at 9:30 a.m. on Wednesday, April 16, 1986, at the Civic Auditorium in San Francisco, California.

Stock and Bond Information

Information about AT&T common and preferred stock, bonds, dividends or interest payments and about the Dividend Reinvestment and Stock Purchase Plan can be obtained from the company's transfer agent, American Transtech Inc., by calling without charge: 1 800 348-8288. Mailed inquiries should be addressed to AT&T, c/o American Transtech, P.O. Box 45048, Jacksonville, Florida 32232-5048.

Certificates and documents in support of stock transfers should also be sent to the above address.

American Transtech maintains an office for bank and broker services at 250 Broadway, 15th Floor, New York, NY 10007.

Shareowner Information

Available upon request by writing to:

Secretary's Department, AT&T, Room 3200P2, 550 Madison Avenue, New York, NY 10022

- Form 10-K, AT&T's annual report to the Securities and Exchange Commission
- For visually impaired shareowners, the AT&T annual report on audio cassette

Secretary, AT&T Foundation, Room 2400, 550 Madison Avenue, New York, NY 10022

- A report on AT&T philanthropy in 1984 and 1985

Treasury Department, AT&T Credit Corporation, 100 South Jefferson Road, Whippany, NJ 07981

- AT&T Credit Corporation's annual report

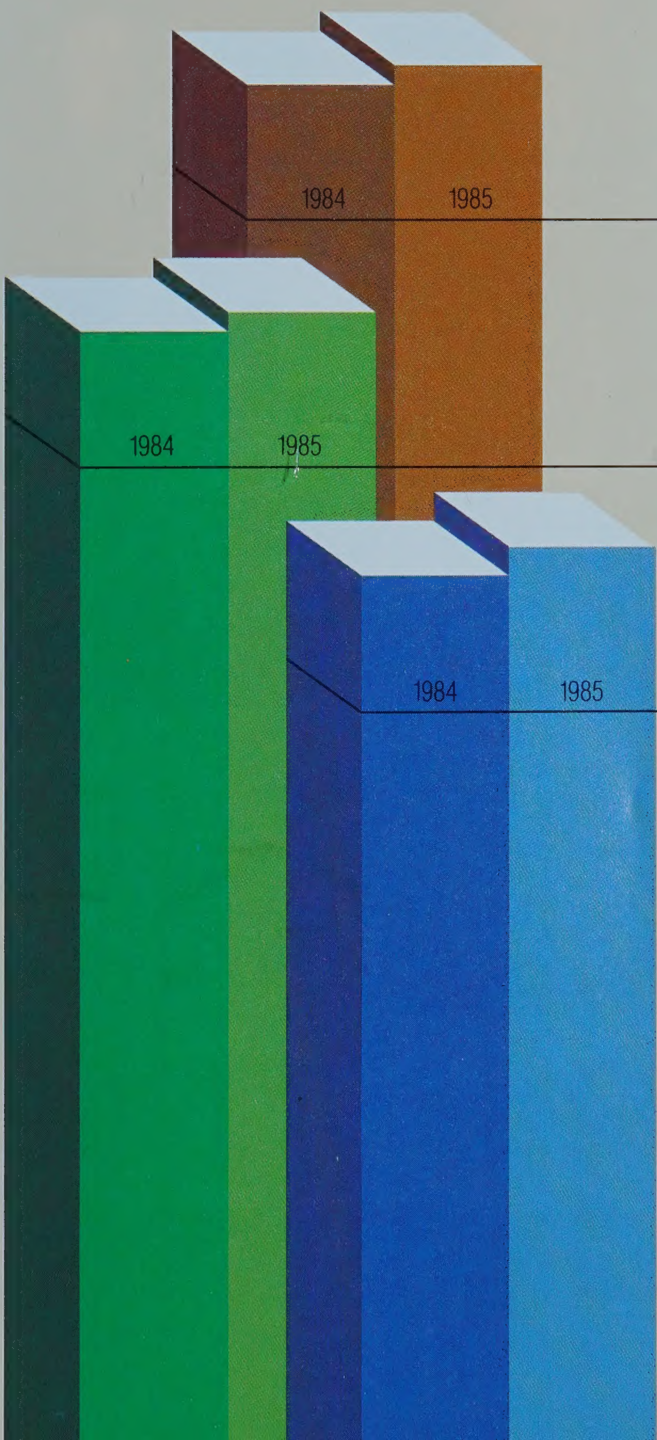
General questions or comments about the Company should be directed to:
Corporate Vice President and Secretary, AT&T, Room 3309, 550 Madison Avenue, New York, NY 10022

The telephone number of AT&T headquarters in New York City is 212 605-5500

Inside This 1985 Annual Report

FINANCIAL HIGHLIGHTS

Dollars in millions (except per share amounts)	**1985**	1984	Percent Increase
Total Operating Revenues	**$34,910**	$33,188	5.2
Total Operating Costs and Expenses	**31,923**	30,893	3.3
Net Income	**1,557**	1,370	13.6
Earnings per Common Share	**1.37**	1.25	9.6
Dividends Declared per Common Share	**1.20**	1.20	–
Return on Average Common Equity	**10.1%**	9.5%	–



1985...A building year

Revenues and sales grew 5.2 percent

Despite intense domestic and foreign competition, sales increased. Our new products are beginning to take hold in their markets

Operating expenses rose at a slower rate than revenues, 3.3 percent

This reflects the progress we made in controlling our costs

Net income increased 13.6 percent

We improved in our second year of "new business," but look to better earnings performance in the future

1986 objectives

- To grow profitably in the markets we serve
- To continue to find more innovative and cost effective ways to meet customer needs and operate our business

AT&T Chairman Charles L. Brown,
in the foreground, and members of the Office of the Chairman:
(from left)
Executive Vice President Charles Marshall,
Senior Vice President and General Counsel Howard J. Trienens,
AT&T Information Systems Chairman Robert E. Allen,
AT&T Communications Chairman Randall L. Tobias,
Executive Vice President Morris Tanenbaum
and President James E. Olson.

REPORT OF THE CHAIRMAN

AT&T earned $1.37 a share in 1985, compared with $1.25 a share the year before. Revenues for the year amounted to $34.9 billion. Net income was $1.56 billion. Highlights of AT&T's financial results are listed on Page 1, and a detailed discussion and analysis begins on Page 16.

Dear AT&T Shareowner:

We made progress in 1985 toward achieving a satisfactory profit level.

On the upside, our earnings in 1985 improved over 1984, and we look for further improvement in 1986. On the downside, the pace of the progress we are making still falls short of our own expectations. We are doing better, but still not well enough.

At the same time, however, we have no reservations about our long term prospects. The business of moving and managing information is the foundation of the new economy now taking shape here at home and around much of the world. We are leaders in this business–the company to watch. We have the right people, the experience, the resources and the determination to come out on top.

To get an accurate perspective on AT&T in 1985 it is helpful to look back at where we were less than a decade ago.

AT&T had long before earned its place among the most successful business enterprises in American history. We operated in unique circumstances, having grown large and successful not in the arena of competition but in the more restrictive environment of a regulated monopoly.

Through hard work and dedication, the people of AT&T, the Bell telephone companies, Western Electric, Bell Laboratories and what was then called the Long Lines Department had brought to this nation the finest telephone service in the world.

And yet we were a company under siege.

A series of regulatory and judicial decisions over the years had opened the industry to competition while purposely keeping AT&T from joining the competition on anything near equal terms. Congressional reorganization of the industry seemed annually to be a real possibility. The Department of Justice was suing to dismantle the Bell System on antitrust charges. Moreover, it was our reading of public opinion that Americans believed that competition would bring consumer benefits that a regulated monopoly could not.

It was clear to us that we were losing control of our corporate destiny. Only by acquiescing to the government's pursuit of a dismembered Bell System could we ever hope to regain that control. And so we agreed to divest the local telephone operating companies.

We then went through the most shattering reorganization in business history, creating the basis for seven strong regional telephone holding companies and restructuring the remaining AT&T organization to suit a new environment.

Two years after divestiture, the initiative is back in our own hands. Artificial regulatory constraints and old antitrust issues that sapped our time and energies are fading away, albeit slowly. More and more, we profit or not only by our performance in the marketplace.

> We are doing better,
> but still not well enough

We have learned some hard lessons and suffered some disappointments along the way. But we have also demonstrated that we are strong competitors and aggressive marketers.

It now is up to the managers of this enterprise to ignite the competitive resources within the company so that we may begin accelerating our growth and profitability.

A sense that AT&T is truly an international business has begun to pervade all aspects of our business. We have taken steps to establish AT&T as a major international competitor, forming alliances with strong partners abroad.

In the long distance business our competitors, helped by massive subsidies decreed by the government, continue to make inroads. But, at the same time, our business also continues to grow as we expand the range of services and options available to our customers, domestically and internationally. This is a healthy, profitable part of our business.

We offer the industry's premier digital switching system, and we are the world's leader in producing fiber optic cable.

We are regaining leadership in the markets for communications and information systems for large and small businesses. We are introducing innovative networks to improve the efficiency and profitability of our customers' operations. And we continue to serve the consumer market for quality telephones and related products and services.

Although we are still new to the business of selling computers, we are beginning to make headway on the basis of strong products and networking capabilities which we continue to enhance.

We continue, too, to achieve technological breakthroughs in developing and producing components, including microchips, for use in our own products and, to a limited extent, for sale to others.

My confidence in the future of AT&T is based on strengths that I believe make this company what we advertise it to be: the right choice. The right choice to invest in, to do business with, to work for.

Foremost among these strengths are the people of AT&T. They are skilled, experienced people of diverse ethnic and racial origins who want to see our customers satisfied and who want to see this business succeed.

The company's need to cut costs and consolidate resources made 1985 another difficult year for many of our employees. The adjustments involved in our becoming a smaller-sized corporation operating in a much more competitive world inevitably have lessened the job security that was associated with AT&T in other times and circumstances. These are our objectives: to create a more stable employment situation; to remain a company that attracts talented people; to provide good jobs and opportunities for advancement based on qualifications and performance, and to have appropriate representation of women and minorities in every level of the company.

Another strength–closely identified with AT&T for so many years–is quality. We literally wrote the book on quality.

When customers do business with us, we want them to know they are buying quality–that AT&T does it right the first time. This is a big part of what excellence in

We have demonstrated that we are strong competitors and aggressive marketers

business is all about, and it is excellence that we strive for in all we do.

Customer satisfaction is something else we know more than a little about. We built our reputation on the quality of service we provided as the nation's "telephone company," and it is on service that we are staking that reputation as a leader in the information movement and management business.

Many companies employ advanced technology. AT&T's strength lies not just in applying individual technologies but in the breadth and depth of our total technological expertise.

One of the principal uses to which we put that expertise is to tie together into networks the products, systems and components that we and others manufacture. We see this capability as our most distinctive competitive edge.

The right choice to invest in, to do business with, to work for

Today, still in the formative stages of the information age, we in this industry have new promises to keep: to use our advanced technology to give the nation a broader dimension of service, a dimension that improves the way we work and live as dramatically as the telephone did in the past.

The great accomplishment of the past was the provision of readily accessible voice communications to everyone everywhere, rich or poor, urban or rural. The universalization of telephone service represents a vision that inspired and shaped our efforts for most of the 20th Century. It now provides the model for a new vision that can inspire and shape our efforts well into the 21st Century.

AT&T intends to play a pioneering role in helping to universalize the information age. Our vision is of a global network that will permit anyone, anywhere and at any time, to send or receive any kind of information without technical barriers.

That is a goal worthy of the industry, of this company and of the people of AT&T.

This is my last annual report letter as Chairman of AT&T. I plan to retire in August of 1986. My years in this job have been marked by turmoil rarely experienced by a corporation's chief executive. Throughout it all, however, I have been sustained and encouraged by the faith and support of the world's largest and most loyal body of shareowners. And, of course, by a most dedicated body of employees.

I believe the assets of the former Bell System are now deployed in a way that has given its employees the opportunity to do their best work–and, at the same time, in a way that has protected the investment of its shareowners.

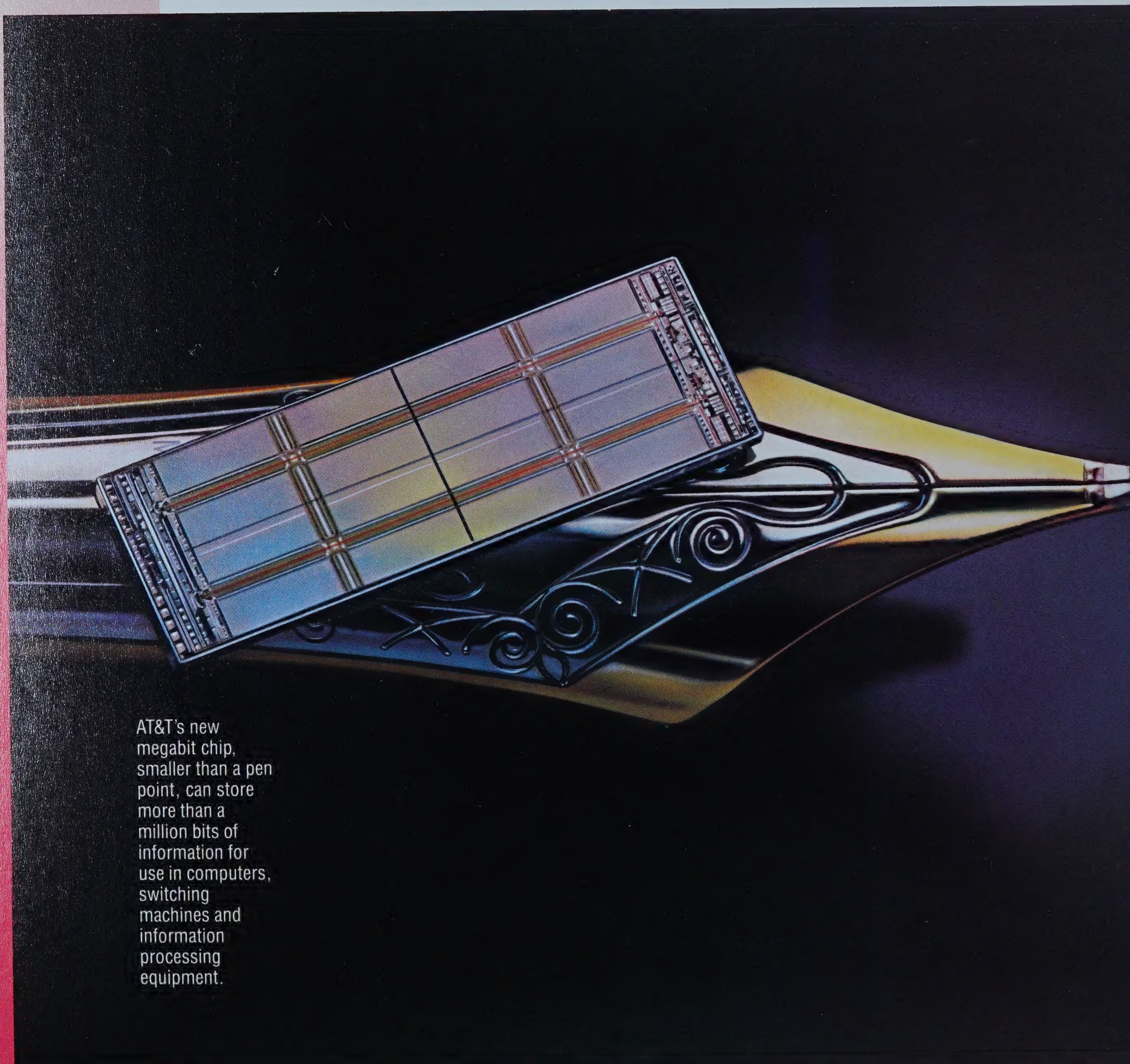
My thanks and best wishes go to all of you.

C. Brown

C. L. BROWN
February 10, 1986

What are AT&T's markets? What are its principal products and services? Who are its customers? What are its achievements, its problems? What strategies is AT&T following in its pursuit of success in the marketplace? What challenges does the company face, and what is it doing about them?

This 1985 annual report gives AT&T shareowners answers to these basic questions about the company.



AT&T's new megabit chip, smaller than a pen point, can store more than a million bits of information for use in computers, switching machines and information processing equipment.

AT&T's overall mission is to provide its customers, worldwide, with products, services and systems for the movement and management of information.

The company offers domestic and international long distance telecommunications services that can be interconnected with the information systems of AT&T and others.

The company also designs, manufactures, markets and services equipment for telecommunications networks; information systems, including computers, and networks for offices and factories; telephone products for homes and businesses; and related electronic components for high-technology products.

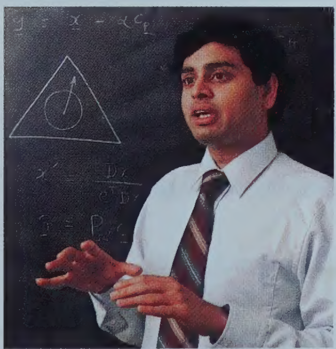
These products and services are designed to meet the needs of three broad categories of customers: the users of telecommunications and information services, including residential, government and business customers; the providers of communications and information services, including telephone companies and other communications agencies around the world; and manufacturers of telecommunications, data processing and other electronic equipment.

The company is dedicated to offering system solutions to meet customers' needs. Our products and services are designed for compatibility.

The organizations that make up AT&T are interrelated and managed as a single enterprise.

Technology: A Strategy

AT&T's business strategy is founded on using our technological leadership to meet customer needs.

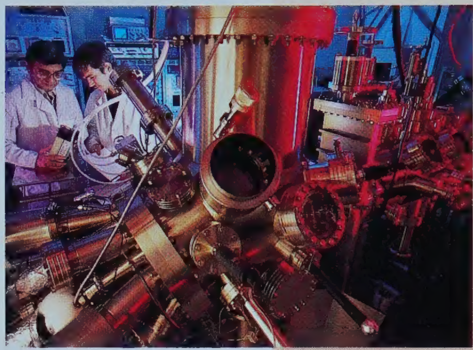


AT&T Bell Laboratories mathematician Narendra Karmarkar.

We are working at the boundaries of science and engineering, quickly bringing the benefits of both to the marketplace.

Underpinning the company's consistent leadership in technology is the research and development work done at AT&T Bell Laboratories and our associated R&D facilities.

A breakthrough mathematical formula, or algorithm, was put to experimental use at AT&T during the year. Called the Karmarkar Algorithm for Linear Programming, after its creator at AT&T Bell Laboratories, the innovation can quickly solve complex problems with hundreds of thousands of variables. It eventually may be employed to solve other costly, complex business problems.



The extraordinary precision of this molecular beam epitaxy machine allows AT&T scientists to build semiconductor chips atomic layer by atomic layer.

One of our research groups last year devised an artificial intelligence program that designs customized microchips in a fraction of the time it takes human experts.

Scientists at AT&T Bell Laboratories tested experimental electronic devices that mimic the way nerve cells work in the brain. Another research group is exploring optical computers that use light rather than electricity. These and other activities are part of our forward-looking efforts to devise wholly new computers, including "fifth-generation" computers that run at superfast speed and may one day emulate human reasoning.

Our researchers also built and demonstrated the world's fastest semiconductor switch in 1985, and held that record as this report was being prepared. The device, using components as small as one-third of a millionth of a meter, can turn an electrical signal on and off in 5.8 trillionths of a second.

Several times during the year, Bell Labs scientists set new records for lightwave signal transmission. One such experiment demonstrated a system with a capacity ten times that of today's most advanced fiber optic system. And another experimental test combined ten laser beams in a single glass fiber to send 20 billion bits of information a second over a 42-mile length of fiber–roughly equivalent to sending the entire text of ten 30-volume encyclopedias in a second.

A Global Perspective

Most large businesses take a global view of their marketplace. AT&T is no exception.

Our goal is to become the leading international provider of information movement and management products and services in the 1990s. We do not underestimate the magnitude of the challenge associated with this goal.

We already are a leader in the provision of international telecommunications services.

Beginning the decade with a modest international product marketing presence, we now have 24 offices strategically located around the world and sell products in some 90 countries. We will establish a

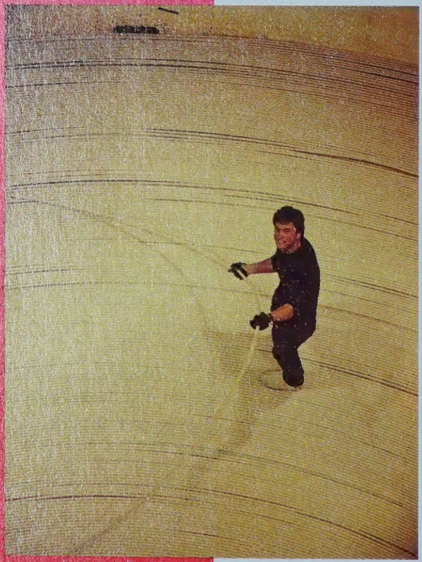
AT&T's Telstar 303 satellite being deployed from the Space Shuttle Discovery.

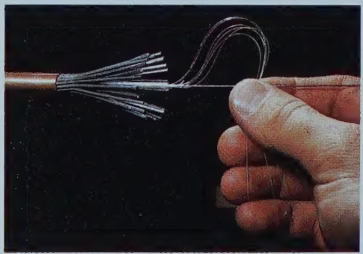
AT&T's products and services drew a large and inquisitive audience at the company's first privately held exhibit for key Japanese business people in Tokyo.

regional headquarters in Europe in 1986.

The company undertook a dramatic expansion in international activities in 1985, making major strides toward establishing itself as a worldwide competitor. We did so through direct sales, acquisitions, joint venture companies, and co-marketing agreements with overseas partners. (See the back cover for a listing of AT&T's major international activities.)

We began the year with strong partnerships already established in Europe for the manufacture and marketing there of AT&T transmission and switching equipment, and for the distribution of AT&T computers and other business information systems.





AT&T is the world leader in the manufacture of lightwave cable (close-up). Specially designed undersea lightwave cable, shown here being coiled into the hold of an AT&T cable-laying ship, will span both the Atlantic and Pacific Oceans.

We formed a London-based unit to market and license the UNIX™ System V computer operating system throughout Europe. And we signed a joint venture agreement to form a new company in Spain to manufacture custom integrated circuits for the European market.

In the Middle East, the company completed major telecommunications projects in Egypt and Saudi Arabia. Through strategic partnerships in the Far East, AT&T is manufacturing electronic switching components, integrated circuits, the 5ESS™ digital switch and fiber optic cable for sale in the Pacific Basin. We also began making residence telephones in our own manufacturing facility in Singapore.

In Japan, we established a company to develop and market a Japanese-language version of our UNIX computer operating system; created a company to market AT&T small business telephone systems; and reached agreements with local companies to distribute our 3B2 computers there.

We opened an office in Beijing, capital of the People's Republic of China, and made our first sale of a 5ESS switch in that country.

In our role as an international provider of long distance telecommunications services, our strategy is to diversify our global offerings to maintain our leadership in the voice market and to strengthen our foothold in the smaller, but rapidly growing, data market.

AT&T provides telecommunications links with more than 250 countries and locations, serving many with the same voice, data and image services that it helped pioneer in the United States.

In partnership with other U.S. and overseas carriers, the company began trial cable-laying operations for TAT-8, the first fiber optic cable designed to span the Atlantic. Service is planned for 1988. Agreement was also reached with other U.S. carriers and overseas telecommunications agencies to construct, after regulatory approval, another undersea fiber optic, or lightwave, system–this one connecting California, Hawaii, Guam, the Philippines and Japan. These projects followed the successful installation in September of the first deep-water undersea lightwave system between two of Spain's Canary Islands. This cable is capable of handling up to 40,000 simultaneous telephone calls.

AT&T PRODUCTS AND SERVICES

The movement and management of information is a new and evolving industry, and central to it are the concepts of networking and "open architecture" that make possible the tying together of separate products, systems and networks.

Network systems

A network is an information system providing the ability to receive, transmit, switch and process information among a variety of users.

Switching systems establish the electronic connections for various kinds of information transactions–voice, data, image and video. The local exchange companies–Bell and non-Bell–are rapidly deploying digital switching to modernize their networks. AT&T responded by shipping 6.5 million lines of our flagship switching system, the 5ESS switch, more than double the volume shipped in 1984. This represents the largest, fastest, most successful product build-up in AT&T's history.

A notable example of AT&T's ability to put its research to work is the recent development of a new,

long-haul lightwave telecommunications system for high-capacity digital transmission. This system, placed in service in January 1986, is capable of carrying more than 6,000 calls on a single pair of glass fibers and has the potential to carry up to 24,000 calls.

By the end of 1987, the company expects to have more than 10,000 route miles of lightguide and about 20,000 route miles of digital radio facilities. Combined with state-of-the-art switching techniques, AT&T is creating a computerized, programmable network that increasingly will permit customers to custom-make their own services.

Responding to the installation of lightguide transmission facilities by local telephone companies, AT&T offers its VIVID™ Video Teleconferencing System, which permits the companies to provide voice, data, facsimile and graphics capabilities in addition to video teleconferencing.

Our strategy embraces a rapid, but orderly, introduction of new digital technology. We envision the complete digitization of local and national networks during the 1990s. This digitization will permit ongoing conversion to Integrated Services Digital Network (ISDN), a global standard that gives customers voice, data and signaling services on a single line.

In 1985, AT&T announced its support of international ISDN standards and its intention to supply a host of innovative, revenue-producing ISDN features for the 5ESS switch. These features will be available to local telephone companies in 1987. The first office application of ISDN on the 5ESS switch, with Illinois Bell Telephone Company, is scheduled to start within a year.

The adoption of ISDN standards marks the first step toward a new era of widely available, economical, innovative new services–Universal Information Services–providing ready access to information worldwide through easy-to-use terminals.

Information systems

Central to our development of products and services is a basic strategy that AT&T products operate efficiently as part of an integrated information system. Called "open architecture," this strategy means that AT&T products, networks and services are engineered for compatibility with each other and, increasingly, with products and services designed and offered by others.

It means our customers will not become "technology-bound," tied to a single supplier by unique technical constraints and standards.

Telephone companies are important customers of AT&T. An AT&T technician inserts a circuit pack into a newly installed 5ESS digital switch at a Pacific Bell office in California.

Moreover, our strategic aim is to ensure the longevity and usefulness of AT&T equipment to protect the customer's investment.

Private branch exchanges (PBXs) are information movement controllers that connect voice and data terminals throughout a customer's location. AT&T's System 75 and System 85 PBXs are designed to serve medium and large businesses. These advanced digital PBXs can be configured to handle demands ranging from fewer than 100 users to more than 100,000.

Our products for small businesses include the Merlin® communications system. Two new models were introduced in 1985, rounding out this product line.

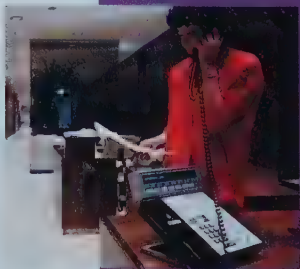
Since we entered the commercial computer business in 1984, AT&T has introduced the most complete line of computers in the shortest time of any company in the field. Our overall strategy is to integrate our computers with other high-tech information products in ways that make a computer as easy to use as a phone.

For the personal computer market, AT&T introduced the highly advanced AT&T PC 6300 Plus, designed to run both the MS-DOS* and UNIX™ operating systems simultaneously.

MS-DOS and UNIX are operating systems: complex sets of coded instructions that govern the internal workings of a computer. MS-DOS is the most popular system for personal computers. UNIX is an AT&T system that enables a computer to do many tasks at the same time; it is becoming increasingly

*MS-DOS is a trademark of Microsoft Corp.

AT&T technicians put a System 85 PBX through its paces during manufacturing at the company's Denver Works. Below, a First National Bank of Chicago employee uses a System 85 digital display terminal.



With the information listed on this "soft-touch" screen, using the AT&T Personal Terminal is a simple matter. At the University of Pittsburgh, an AT&T information system electronically ties together the campus and its information resources.

popular for both large and small computer systems. This capability to run both operating systems gives the customer access to thousands of applications programs and combines them with the unique powers of the UNIX system.

To protect the customer's investment in AT&T equipment, the company also offers an upgrade package that permits owners of the economical PC 6300, introduced in 1984, to convert their machines to the PC 6300 PLUS configuration.

AT&T's family of 3B computer products was expanded in 1985 with the addition of several new or improved minicomputers, including the UNIX Model 3B1. This small, powerful computer bridges the gap between personal computers and minicomputers, and it, too, can run UNIX and MS-DOS software simultaneously.

In software, we are aggressively stimulating the design and development of UNIX applications programs. By year's end, more than 160 software packages for our UNIX personal computer had been introduced, and nearly 1,000 UNIX applications programs were available for AT&T UNIX-based minicomputers. That number will triple by the end of 1986.

AT&T's 6500 Multifunction Communications System was introduced in 1985 and is a major entry in the "3270 compatible" marketplace. Typically, products for this marketplace include terminals and other equipment that interconnect with the large computers used by many big companies and government agencies.

The versatile Merlin communications system offers big business performance at a small business price.

We also introduced the AT&T Personal Terminal, which features a patented "soft-touch" screen that flexes when pressed. This product is both a highly advanced telephone and a data terminal for such tasks as information retrieval and electronic mail.

In 1985, we introduced an improved Information Systems Network. It is a local and wide area premises data network that can tie together up to 1,900 data devices, from personal computers to mainframes, into a single system.

We also announced the AT&T STARLAN local area network to allow users to interconnect dissimilar computers within an office or building. STARLAN works with a related product, the new AT&T Premises Distribution System (PDS), a wiring scheme that uses both fiber optic cables and ordinary copper wiring. It is easier to install and less expensive than coaxial cable and often can use wire already in place at the customer location.

Consumer telephones

We continued in 1985 to serve the consumer telephone market, offering a full range of basic consumer telephones.

Other popular consumer items include cordless telephones, answering systems, mobile cellular phones, automatic dialers, speakerphones, and wiring and accessory products for customers to use when installing or moving their telephones.

Although the number of AT&T telephones leased by customers has declined, many customers find leasing a valuable solution to their home communications needs. Immediate replacement service and exchange of color at no extra charge are benefits unique to leasing.

Our overall objective is to offer products, whether purchased or leased, that meet customers' needs while providing the best quality and value for the dollar.

Service support

The quality of AT&T products is directly related to the quality of the AT&T service available before and after the customer purchases AT&T equipment.

Through a nationwide service network of several hundred technical, logistical and administrative centers, AT&T provides a wide range of support

AT&T provides round-the-clock technical support for System 75, System 85 and other PBXs. Service teams can simulate customer difficulties on their equipment and rapidly devise solutions.

services, including product hotlines, remote diagnosis of problems, software operating and applications systems, and design of customer networks. With 19,000 systems technicians, AT&T maintains the largest service force of its kind in the industry, working on customer premises or in regional teams

composed of voice, data and software experts.

In 1985, AT&T people handled more than 750,000 service requests a month, meeting more than 90 percent of their installation and maintenance commitments on time. We also handled 35,000 customer telephone calls daily.

Beyond installation and maintenance, service offerings also include technical consulting, project implementation and complete service support for communications and office automation systems.

Components and electronic systems

AT&T has been for many years a major designer and developer of components and electronic systems–from customized devices that form an integral part of every AT&T flagship system to the most sophisticated microprocessors and memory devices.

Until recently, use of these components was limited mainly to our own products. But we now also offer some advanced components for sale to other companies.

In 1985, we felt the impact of a softening demand for microelectronic components–the result of an industry-wide slump and revisions in our own early-year equipment sales forecasts.

The company scored an important success in 1985 by becoming the first manufacturer in the world to begin production of megabit memory chips, devices no larger than a fingernail that can store more than one million bits of information. AT&T has already begun to incorporate the megabit chip into future designs for its products and to market this new device to other manufacturers.

The WE®32100 chip set is another advance in integrated circuitry introduced to the commercial marketplace by AT&T during the year. This chip set is a family of components, including a powerful microprocessor along with auxiliary chips that, together, perform computerlike functions with twice the processing capability of the previous generation of components.

In addition, a planned third generation microsystem, with twice the capability of the WE32100 chip set, is currently under development.

We also added to our microsystem family with a single-board computer that packs the basic elements necessary to run UNIX System V software on an area no bigger than a steno pad.

A reliable, computer-controlled power system was introduced to protect sensitive data processing equipment from losing information as a result of power fluctuations.

Long distance services

We continued to broaden the scope of our network services, offering the best overall quality and value for long distance calling and building more options and capabilities into our services.

Heavy emphasis was placed on offering integrated voice, data and image solutions for specific customer needs in residence, business and government markets, both domestically and internationally.

AT&T's high-speed ACCUNET® family of digital services can be used for transmission of video, data and graphics information. These services are provided through AT&T Communications' digital network, the largest in the world.

The company provides SKYNET® services through its satellites and earth station facilities for voice, data, video and graphic information. In 1985, we deployed Telstar 303, the third in the Telstar 3 series of domestic satellites.

AT&T WATS provides an economical means for businesses to *make* large volumes of calls to customers, suppliers and employees in distant locations. AT&T 800 Service, on the other hand, allows organizations to *receive* a large volume of calls to a single phone number from locations around the country. Both allow for economical telemarketing programs. AT&T 900 Service permits large numbers of callers to listen to the same message at the same time.

In November, we began offering AT&T MEGACOM℠ and AT&T MEGACOM℠ 800 Services,

AT&T's Richmond (Va.) Works exemplifies state-of-the-art manufacturing techniques. Employees set up and operate production facilities while computers analyze orders, schedules, production and testing operations.

Technicians examine a wafer that will be processed to produce microchips at AT&T's Orlando (Fla.) integrated circuit manufacturing facility.

At AT&T's Message Access Service Center in Norfolk (Va.), customers who are traveling can check their electronic mail by phone.

alternatives to AT&T WATS and AT&T 800 Service. The new services offer high-volume business customers still more flexibility and control, as well as potential cost savings, in serving geographically diverse markets.

Another new service offering–Software Defined Network (SDN) Service–allows large business customers to use portions of our long distance switched network as part of their own internal voice and data communications system.

Internationally, we reached a cooperative agreement with British Telecom International to provide overseas rooftop satellite service for selected customers. And we contracted with another United Kingdom supplier, Mercury Communications Ltd., to provide international private line data services between the United Kingdom and the United States.

"Thank you for using AT&T." Operators at the company's International Operating Center in Pittsburgh assist customers in completing calls around the world.

The company opened its second international calling center at San Francisco International Airport. (The first is at John F. Kennedy International Airport in New York.)

As part of our overall effort to add value to the long distance service we provide, our popular REACH OUT℠ America discount calling plan has attracted more than two million long distance customers. State REACH OUT plans are also available.

Also attracting customers to AT&T Long Distance service was our AT&T Opportunity Calling℠ program. Now in its second year, Opportunity Calling offers discounts and rebates on goods and services to both residence and business customers.

AT&T continues to offer operator assistance around the clock, the ability to call anywhere from anywhere, guaranteed discounts more than 70 percent of the time, and immediate arrangement of credit for misdialed or disconnected calls.

The local telephone companies' implementation in mid-year of a $1-a-month customer line charge was accompanied by a lowering of the access charges we pay them. This helped make possible a reduction in interstate rates of 5.6 percent for our domestic long distance customers. We also lowered prices for many overseas calls.

To further reduce costs, increase efficiency and generate sales opportunities, the company plans, beginning in late 1986, to assume responsibility for many of the long distance billing services currently provided for AT&T by the local telephone companies. Combined billing for long distance service and equipment leasing is also under study.

The Federal Communications Commission (FCC) instituted a major change in 1985 in the carrier selection, or equal access, process under way throughout the nation. The Commission ruled that customers who fail to select a long distance carrier will have one selected for them at random and encouraged customers to make an active selection of a long distance company.

As expected, our revenue share of the United States long distance market has declined since divestiture because of the increased competition in the long distance business. However, our business continues to increase as the total market grows. AT&T is competing aggressively and responsibly for long distance customers, and we are striving to eliminate lingering subsidies.

NEW VENTURES

Expanding beyond its traditional markets, AT&T in 1985 began a number of new ventures, capitalizing on our employees' skills in fields allied to the business as well as in new markets. Joint ventures and co-marketing agreements with other companies provide a rapid and cost-effective route to these new markets.

AT&T formed a partnership–COVIDEA–with Chemical Bank, Time Inc., and, subject to government approval, Bank of America. The partnership will market electronic banking, brokerage and other services nationally to consumers and small businesses.

AT&T and Quotron System, Inc. agreed to

market jointly an integrated financial information system for the brokerage industry. The system will allow users to simultaneously view current market prices, speak with clients and review a client's portfolio. AT&T will provide its UNIX PC computer and its STARLAN local area network to process and distribute the financial information supplied by Quotron.

In addition to these strategic ventures and alliances, the company acquired equity interests in three software development firms–Mitek, Omnicad and Intermetrics–and in Counterpoint Computers, which offers computers for the scientific and engineering markets.

The purchase of the chip-making, integrated circuit design and sales facilities of Synertek–a Honeywell, Inc. subsidiary–in California, Bangkok, Singapore and Munich will strengthen AT&T's marketing and sales position in Europe and Asia, as well as in the domestic market.

In addition to joint ventures, another path being explored is that of *intrapreneurship*–that is, stimulation and funding of small start-up enterprises within the company.

The company evaluates employee proposals for small but promising new ventures and selects those that show the greatest potential. Frequently, the employees involved in these projects forgo some part of their ordinary compensation in exchange for a share of the return on a successful enterprise.

Two AT&T groups are pursuing opportunities in the medical field. One is developing integrated information systems for hospitals and professionals. Another is concentrating on the digital storage and transmission of images to support radiology activities.

AT&T Electronic Photography and Imaging Center, organized by a small group of engineers in Indianapolis, has created a system that allows personal computer users to store and process a series of single-frame video pictures on a disk. The pictures can be enhanced, reduced, have colors altered, or text added. The system is far less expensive than any competing system.

A device that electrically detects metal defects–thereby improving manufacturing quality and productivity–was also brought to market by an AT&T intrapreneurial group.

Yet another venture group, AT&T Conversant Systems, manufactures computer-controlled speech recognition and response products that interpret spoken commands and respond verbally.

These systems can be used to activate and operate automated data systems for such applications as credit card verification.

CHALLENGES AND RESPONSES

Cost reduction has been–and will continue to be–a major challenge. It became very clear as we entered the hotly competitive post-divestiture environment that our cost structure was too high to achieve a level of earnings expected of a high-technology business.

As a result, we have sought to reduce costs in all parts of our business. These efforts have included the closing and consolidation of manufacturing and service facilities, the combining and streamlining of staff operations, the introduction of new cost-saving technologies, a freeze on management salary structures, and substantial force reductions.

Most of the force reductions occurred as we consolidated resources and adjusted to a lower demand than we had anticipated for some of our product lines. At year's end we employed 27,000 fewer people throughout AT&T than when the year began.

Unlike most of the companies with which we compete, we have also been handicapped by regulatory constraints.

In 1985, a major regulatory handicap was eliminated when the FCC decided to ease the regulatory barriers that separated the provision of customer premises equipment from the rest of our business.

In serving our larger business customers we are now able to take a more integrated approach to solving their equipment and network service needs.

And to better serve our Federal government customers, we have consolidated three AT&T units into one organization.

In short, we are now in a much better position to do business as a single enterprise.

For our customers this will mean better service. For the company it will mean we can manage our costs more efficiently, enhance our profitability and

Three of the intrapreneurs who began AT&T Electronic Photography and Imaging Center, a new venture.

The COMMVIEW System, the first product from AT&T's Medical Diagnostic Systems, allows doctors at Duke University to examine electronically enhanced images, such as X-rays, from the next room or from thousands of miles away.

Sales to the Federal government in 1985 included a contract to install a nationwide microwave communications network for the Federal Aviation Administration.

ultimately lower the prices of our products and services.

We view this development as a positive step, part of an effort by the FCC to reduce regulation in the telecommunications business. Nevertheless, AT&T continues to be the only company whose prices, offerings and earnings for long distance services are closely regulated–this despite the fact that our competitors include major companies making large capital investments in long distance networks and who provide some service to roughly half of the business customers who spend more than $50 a month on long distance.

We have urged the FCC to emulate regulatory authorities in 22 states who have acted to equalize the ground rules for all long distance telecommunications carriers under their jurisdiction. At the same time, however, many other states continue the uneven regulation that has made it difficult–and in some states, impossible–for the company to make a profit from its intrastate long distance operations.

At our American Transtech offices in Jacksonville (Fla.), shareowner service representatives handle nearly two million inquiries a year.

Regulatory requirements imposed prior to divestiture continue to impede the efficient integration of certain technically sophisticated network offerings with the rest of our business. We have requested, for the sake of promoting competition and market efficiency, that these remaining restraints be eased. Partly in response to our request, the FCC last July began a proceeding in which it has tentatively decided to eliminate the restrictions.

As the year concluded, Congress was debating national economic policy on many fronts: tax reform, trade issues and the Federal budget. The outcome of these discussions will affect the company and its markets, for better or worse, in 1986 and beyond. We have made the most forceful case we can for an economic policy that encourages savings and investment, without penalizing capital-intensive companies and worsening the trade gap or budget deficit.

AT&T Credit Corporation, AT&T's wholly owned finance subsidiary, began operations in January, 1985, and by year's end had increased its assets to more than $700 million, becoming one of the largest "captive" finance companies in the U.S. This company is responsible for offering creative financing that enhances the marketability of AT&T products and services.

AT&T Resource Management has responsibility for a sizable share–$1.4 billion–of AT&T's investment in real estate and related capital assets. It is responsible for overseeing the design and construction of most new buildings and manages real estate assets to yield long-term financial benefits by lowering occupancy costs and entering joint ventures with real estate developers.

Actuarial Sciences Associates, Inc., was established as a subsidiary in 1985 to provide AT&T and other companies with a wide range of financial consulting services in connection with employee benefit plans, including pension and medical plans.

American Transtech Inc. provides services such as stock transfers, direct marketing, information distribution, data security, and financial and benefits record-keeping. Its customers include AT&T, the Regional Bell Telephone Companies and companies outside the telephone business. In 1985, American Transtech mailed out more than 300 million items, including 20 million catalogs for the AT&T Opportunity Calling program. It processed 6.5 million returned proxy cards and two million return-mail cards, and reconciled almost five million rebate checks and savings certificates.

The AT&T Foundation, our principal vehicle for corporate philanthropy, made 1,052 grants totaling $25 million in support of educational, health care, social action and cultural organizations during 1985, including substantial grants to four medical schools with enrollments representing almost a quarter of the nation's first-year black medical students. In addition, AT&T donated directly $5.9 million to charities in communities across the country where AT&T operates, and computers with a fair market value of $44.6 million were donated to colleges for selected projects.

Report of Management

The accompanying financial statements, which consolidate the accounts of American Telephone and Telegraph Company and its subsidiaries, have been prepared in conformity with generally accepted accounting principles.

The integrity and objectivity of data in these financial statements, including estimates and judgments relating to matters not concluded by year-end, are the responsibility of management as is all other information included in this Annual Report unless indicated otherwise. To this end, management maintains a system of internal accounting control. Our internal auditors monitor compliance with it in connection with an annual plan of internal audits. The system of internal accounting control, on an ongoing basis, is reviewed, evaluated and revised as necessary in view of the results of internal and independent audits, management recommendations, changes in the Company's business, and other conditions which come to management's attention. Management believes that the Company's system, taken as a whole, provides reasonable assurance (1) that financial records are adequate and can be relied upon to permit the preparation of financial statements in conformity with generally accepted accounting principles and (2) that access to assets is permitted only in accordance with management's authorizations. Recorded assets are compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences. Management also seeks to assure the objectivity and integrity of the Company's financial data by the careful selection of managers, by organizational arrangements that provide an appropriate division of responsibility, and by informational programs aimed at assuring that its policies, standards, and managerial authorities are understood throughout the organization.

These financial statements have been examined by Coopers & Lybrand, independent Certified Public Accountants. Their examination is in accordance with generally accepted auditing standards and includes selective tests of transactions and a review of internal accounting controls.

The Audit Committee of the Board of Directors, which is composed of Directors who are not employees, meets periodically with management, the internal auditors, and the independent auditors to review the manner in which they are performing their responsibilities and to discuss auditing, internal accounting controls, and financial reporting matters. Both the internal auditors and the independent auditors periodically meet alone with the Audit Committee and have free access to the Audit Committee at any time.

Robert M. Kavner

Robert M. Kavner
Senior Vice President and Chief Financial Officer

Report of Independent Certified Public Accountants

To the Shareowners of American Telephone and Telegraph Company:

We have examined the consolidated balance sheets of American Telephone and Telegraph Company and subsidiaries at December 31, 1985 and 1984, and the related consolidated statements of income and funds flow for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of American Telephone and Telegraph Company and subsidiaries at December 31, 1985 and 1984, and the consolidated results of their operations and changes in their financial position for the years then ended in conformity with generally accepted accounting principles applied on a consistent basis.

Coopers & Lybrand

1251 Avenue of the Americas
New York, New York
February 10, 1986

Because pre and post-divestiture data are not comparable, this Annual Report does not include information relating to the period before 1984. See also Note (B) to the financial statements.

Results of Operations

Total operating revenues, net of access charges, i.e., payments to Local Exchange Companies for access to their networks, were $34.9 billion in 1985, an increase of $1.7 billion or 5.2 percent over 1984. This increase was due to growth in the sales of services and products which more than offset an anticipated decline in rental revenues.

Service revenues, those which are derived from long distance telecommunications services and also from installation and maintenance services and other services, contributed significantly to the revenue increase. Despite the continued burden of access charges at higher rates than those paid by our competitors, toll services provided by AT&T Communications were the largest contributor, recording a 7.0 percent revenue growth over 1984, primarily from greater message volumes.

The access charge environment improved in 1985 as the Federal Communications Commission ("FCC"), effective June 1, ordered implementation of end-user access payments by residential and single line business customers and an accompanying reduction in payments made by interexchange carriers. In addition, access costs imposed by state regulatory bodies became more equitable in many jurisdictions during 1985. AT&T's access charge estimating and the Local Exchange Companies' access charge billing procedures also improved substantially during 1985.

Competition in the long distance market will continue to intensify as the phase-in of long distance carrier selection, i.e., equal access, continues across the country. AT&T is responding to this increased competition by introducing new service offerings, optional calling plans and promotional plans, and is expecting to share in the continuing growth of the long distance business. In addition, we believe that significant growth opportunities lie ahead for service revenues associated with international calling and special services such as private line and networking services for large users.

Product revenues for 1985, while reflecting a 16.3 percent improvement over 1984, were less than anticipated. This was primarily caused by lower demand for certain products such as telecommunications equipment, computers and other office automation equipment. Despite the softness in market conditions, sales volumes increased in 1985 in such key marketing areas as central office switching, large and mid-sized PBXs, and key telephone systems, primarily due to the performance of our principal products in these areas–the 5ESS, System 85, System 75 and Merlin. In the computer equipment market, AT&T's position is improving as we provide a wider range of products and networking capabilities.

Rental revenues declined as anticipated in 1985, as more customers decided to purchase rather than lease telecommunications equipment. This trend is expected to continue.

Total operating costs and expenses of $31.9 billion in 1985 represented an increase of $1.0 billion or 3.3 percent over 1984.

Cost control continued to be a high priority throughout AT&T in 1985. Actions taken during the year to reduce costs included the closing and consolidation of factory and distribution facilities, substantial force reductions, freezing management salary structures, the streamlining of staff operations, the implementation of cost-saving technologies and other increased internal efficiencies. In addition, relief from certain organizational separation restrictions granted by the FCC on September 30, 1985 will enable the Company to offer fully integrated solutions to the network service and equipment needs of our customers. These actions will further reduce costs and improve our ability to compete.

During 1985, cost of services reflected reductions due to cost controls instituted by management and lower uncollectible charges, cost of products reflected higher than expected charges for inventory writedowns, and cost of rentals reflected higher depreciation rates. Selling, general and administrative expenses reflected higher marketing and selling expenses, offset by lower administrative costs.

Pension cost, which is reflected in all cost and expense categories, amounted to $657.1 million in 1985, a reduction of $386.3 million from 1984. This reduction was primarily due to changes in actuarial assumptions, including investment performance, as discussed in Note (F) to the financial statements. The Company is in the process of evaluating the impact of new Financial Accounting Standards Board pronouncements on accounting for pensions. Although the impact of compliance has not been fully quantified, it is expected that the standards, when implemented, will reduce the Company's pension expense and such reductions could be significant.

Expenditures for research and development were $2.2 billion in 1985, an increase of $22.0 million or 1.0 percent over 1984. The scope of these expenses covers a broad range of activities including basic research, new product design and development, and the enhancement of existing products. The 1985 research and development expense is net of $160.9 million of capitalized software development costs which, under the accounting procedures in effect prior to 1985, would have been included in research and development expense. See Note (A) to the financial statements.

Other income–net declined in 1985 principally from reduced interest income.

Interest expense in 1985 decreased $175.8 million or 20.3 percent from 1984 principally due to the decrease in total debt outstanding and lower interest rates.

During 1985, the Company incurred $2.65 billion in total federal, state, local and foreign tax expense, of which $989.6 million was for taxes on income.

AT&T and Subsidiaries

Consolidated Statements of Income

Years ended December 31

Dollars in millions (except per share amounts)	**1985**	1984*
Sales and Revenues		
Sales of services, net of access charges of $21,521.2 and $20,633.0, respectively	**$17,267.6**	$15,780.8
Sales of products	**11,853.1**	10,189.4
Rental revenues	**5,788.8**	7,217.3
Total operating revenues	**34,909.5**	33,187.5
Costs and Expenses		
Cost of services	**8,086.8**	8,199.4
Cost of products	**7,614.5**	6,405.0
Cost of rentals	**2,889.4**	2,885.3
Selling, general and administrative expenses	**11,123.0**	11,215.9
Research and development expense (C)	**2,209.7**	2,187.7
Total operating costs and expenses (F) (G)	**31,923.4**	30,893.3
Operating income	**2,986.1**	2,294.2
Other income–net (D)	**251.8**	524.5
Interest expense (E)	**691.5**	867.3
Income before income taxes	**2,546.4**	1,951.4
Provision for income taxes (H)	**989.6**	581.5
Net Income	**1,556.8**	1,369.9
Dividends on preferred shares	**109.6**	112.3
Income applicable to common shares	**$ 1,447.2**	$ 1,257.6
Weighted average common shares outstanding (millions)	**1,057.9**	1,009.6
Earnings per Common Share	**$ 1.37**	$ 1.25

*1984 costs and expenses have been reclassified to conform to current presentation. See Note (B).
The notes on pages 22 through 29 are an integral part of the financial statements.

Financial Condition

Current asset management continues to receive priority at AT&T and during 1985 additional procedures were initiated to improve monitoring and control. The Company's cash management policy continues to be to maintain minimum amounts on hand to meet short-term needs and to invest the remainder to provide growth opportunities for the business. Cash and temporary cash investments increased slightly during 1985, but are anticipated to decline somewhat in 1986.

Receivables decreased $374.7 million during 1985, as increased attention was focused on credit and receivables management.

Inventory amounts decreased slightly during the year. In connection with a reorganization bringing together certain manufacturing and marketing operations and modifications in marketing strategies during the third quarter of 1985, inventory was reduced by $180.0 million as a result of the write-downs of certain technologically obsolete equipment. This reduction, however, was partially offset by increases in inventory as a result of weaknesses in certain markets and in inventory control procedures. The Company is implementing improved procedures in this area.

The increase in AT&T investments of $389.4 million in 1985 primarily reflects the investment in AT&T Credit Corporation ("AT&T-Credit") which was formed as a wholly-owned finance subsidiary to support sales and leases of AT&T products by offering competitive financing options to AT&T customers. AT&T-Credit provides an alternative source of capital for AT&T, thus relieving AT&T from the need to provide funds directly for customer financing.

The Company implemented force reduction and downsizing activities in AT&T Information Systems during 1985 to more appropriately structure the business in a highly competitive environment. In September 1985, a liability for the costs associated with these activities, estimated to be approximately $875.0 million, was recorded, of which $550.0 million was absorbed by the reclassification of reserves previously accrued for restructuring the corporation and adjusting the carrying value of assets. The remaining $325.0 million was charged to general and administrative expenses. Concurrently, there was a reversal of a reserve previously accrued for possible refunds that was no longer required which approximated the aforementioned charge to general and administrative expenses.

Property, plant and equipment, net of accumulated depreciation, increased in 1985 due to additions and to a $520.0 million decrease in accumulated depreciation associated with the reclassification of reserves described in the previous paragraph.

Other assets declined principally due to the acquisition of certain long-term receivables by AT&T-Credit, partially offset by the capitalization of software development costs.

Total debt outstanding decreased $432.4 million during 1985. Long-term debt decreased by $1.02 billion principally due to the reclassification to short-term debt of two issues of long-term debt totaling $1.0 billion. Short-term debt increased $587.3 million principally due to the reclassification of long-term debt described in Note (N) to the financial statements, which was partially offset by an early redemption (call) of $300.0 million of debt assumed from The Pacific Telephone and Telegraph Company at divestiture and a scheduled maturity of $250.0 million debt.

Progress was made during 1985 toward the long-term goal of reducing the Company's debt ratio to the 25 to 30 percent range. The debt ratio decreased from 38.5 percent at December 31, 1984 to 36.2 percent at December 31, 1985 as a result of an increase in equity and a reduction in debt outstanding. If preferred shares subject to mandatory redemption were included with debt, the debt ratio would have been 42.0 percent and 44.6 percent at December 31, 1985 and December 31, 1984, respectively.

Equity financing in 1985 totaled $671.0 million from new common equity, of which $245.8 million was obtained through the Company's Shareowner Dividend Reinvestment and Stock Purchase Plan, $368.1 million through employee savings plans and $57.1 million through the Employee Stock Ownership Plan. This increase was partially offset by preferred equity sinking fund redemptions which totaled $36.8 million in 1985.

The impact of inflation on the Company's results and financial position in 1985 is discussed in the Supplementary Data Section beginning on page 30.

AT&T and Subsidiaries

Consolidated Balance Sheets

At December 31

Dollars in millions (except per share amounts)	1985	1984*
Assets		
Current Assets		
Cash and temporary cash investments	$ 2,213.7	$ 2,139.9
Receivables less allowances of $345.6 and $318.4, respectively	8,996.1	9,370.8
Inventories (I)	4,759.3	4,789.2
Deferred income taxes	785.2	751.4
Other current assets	163.3	281.7
Total current assets	16,917.6	17,333.0
Investments (L) (M)	811.1	421.7
Property, plant and equipment–net (J) (K) (U)	22,112.9	21,015.0
Other assets	620.9	1,056.9
Total Assets	$40,462.5	$39,826.6
Liabilities and Shareowners' Equity		
Current Liabilities		
Accounts payable	$ 4,942.8	$ 5,075.7
Payroll and benefit related liabilities	1,915.0	2,113.8
Debt maturing within one year (N)	1,437.4	850.1
Dividends payable	347.8	339.2
Other current liabilities	2,844.5	2,887.7
Total current liabilities	11,487.5	11,266.5
Other Liabilities and Deferred Credits		
Long-term debt including capital leases (K) (O)	7,697.8	8,717.5
Other liabilities	398.3	582.7
Deferred income taxes	2,870.6	2,000.7
Unamortized investment tax credits	1,615.8	1,725.4
Other deferred credits	302.1	277.0
Total other liabilities and deferred credits	12,884.6	13,303.3
Preferred shares subject to mandatory redemption (Q)	1,457.1	1,493.9
Common Shareowners' Equity (R)		
Common shares–par value $1 per share Authorized shares: 1,200,000,000 Outstanding shares: 1,069,330,000 at Dec. 31, 1985; 1,037,678,000 at Dec. 31, 1984	1,069.3	1,037.7
Additional paid-in capital	8,482.7	7,843.3
Retained earnings	5,081.3	4,881.9
Total common shareowners' equity	14,633.3	13,762.9
Total Liabilities and Shareowners' Equity	$40,462.5	$39,826.6

*1984 amounts have been reclassified to conform to current presentation.

The notes on pages 22 through 29 are an integral part of the financial statements.

Funds Flow

Funds from operations in 1985 of $5.56 billion contributed 82.3 percent of the funds provided to support the business. Depreciation, as a source of funds, increased by $453.7 million over 1984 primarily due to higher rates of depreciation which reflect the more rapid technological changes applicable to our plant and equipment. It is expected that funds contributed from operations will increase in 1986 and constitute a greater portion of total funds provided to support the business.

Federal income tax reform currently under consideration by the U.S. Congress would generally lower the statutory corporate income tax rate while repealing the investment tax credit and various other tax credits and deductions. If such legislation is eventually passed, the Company expects the net impact of the legislation to result in an increase in reported earnings but a reduction in cash flow provided by operations.

During 1985, the Company's expenditures for capital investment amounted to $4.58 billion. In addition to outlays for factory modernization and network and special services growth, such expenditures also include investments in joint ventures and acquisitions to assure sources of supply and production and further develop worldwide marketing channels. In 1984, the Company reported capital expenditures of $3.22 billion for additions to property, plant and equipment. Including 1984 investments in joint ventures and acquisitions, total 1984 capital expenditures were $3.61 billion. These expenditures permit the introduction of new product and service offerings to continue at a rapid pace, and are an integral part of the Company's strategy in the information movement and management business.

Dividends declared payable to common shareowners in 1985 were $1.20 per common share representing 88.0 percent of income applicable to common shares. Further market and dividend data may be found on page 32.

The total capital needs of the Company were met primarily by internal sources, with the balance being principally provided by equity financing through the Shareowner Dividend Reinvestment and Stock Purchase Plan and employee savings plans; however, this equity source of financing was discontinued in 1985. Effective October 1, 1985, the Company began purchasing shares on the open market for these plans rather than issuing new shares.

AT&T will continue to make significant investments in productive assets which will enable it to take advantage of future opportunities. Except for possible refinancing of called and maturing debt, it is expected that 1986 capital requirements will be of a similar magnitude to those of 1985 and will be met primarily by internal financing.

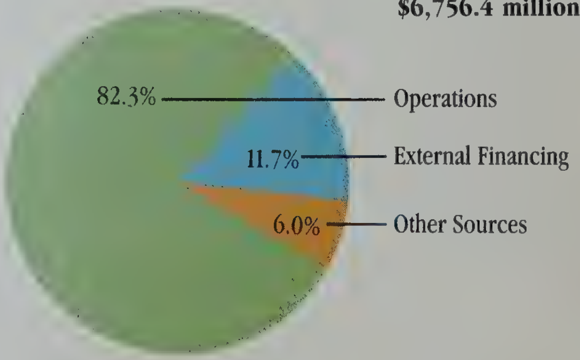
In Conclusion

For AT&T, 1985 was a year of continuing change as the Company strengthened its position as an international supplier of high technology products and services in the information movement and management business. Despite declines in rental revenues and unexpected softness in some markets we serve, we achieved a growth in net income of 13.6 percent.

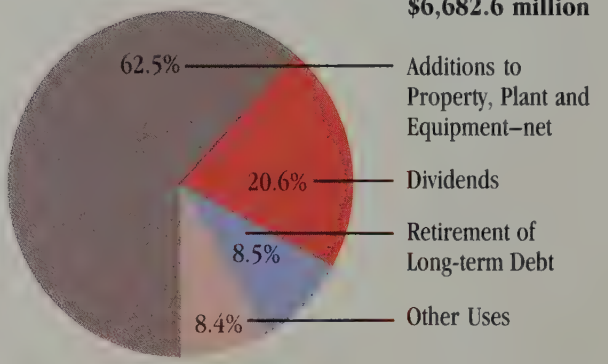
AT&T's ability to serve the marketplace effectively and profitably was enhanced by actions during 1985 which will have a positive influence on future financial results. We analyzed our strengths and weaknesses and proceeded to tighten financial controls and improve results. New products and services continued to be introduced and further cost reductions were made, particularly in AT&T Information Systems. In addition, some measure of needed relief was provided by both federal and state regulators.

We have gained significant knowledge and experience in our new, more intensely competitive environment, and expect to achieve greater earnings growth in the future.

Sources of Funds
$6,756.4 million



Uses of Funds
$6,682.6 million



AT&T and Subsidiaries

Consolidated Statements of Funds Flow

Years ended December 31

Dollars in millions	1985	1984
Funds (cash and temporary cash investments) at January 1	**$ 2,139.9**	$ 5,311.7
Sources of Funds		
From operations:		
Net income	**1,556.8**	1,369.9
Depreciation	**3,231.6**	2,777.9
Deferred income taxes–net	**855.0**	777.3
Less: Equity investment income in excess of dividends	**22.5**	19.9
Other adjustments for non-cash items	**61.4**	11.7
Total from operations	**5,559.5**	4,893.5
From external financing:		
Increase in long-term debt including capital leases	**155.0**	171.1
Issuance of shares, net of redemptions	**634.2**	1,195.6
Total from external financing	**789.2**	1,366.7
From other sources:		
Divestiture cash flow settlements (U)	**–**	175.1
Sales to affiliate of long-term receivables–net (L)	**407.7**	–
Total from other sources	**407.7**	175.1
Total Sources of Funds	**6,756.4**	6,435.3
Uses of Funds		
Additions to property, plant and equipment–net (U)	**4,177.5**	3,462.1
Dividends paid	**1,374.3**	2,326.9
Retirement of long-term debt	**568.6**	427.0
Increase in investments–net	**357.4**	67.9
Increase in other assets	**123.0**	435.5
Decrease in short-term borrowing–net	**22.2**	445.6
Net change in working capital, detailed below	**(148.1)**	1,892.5
Other–net	**207.7**	549.6
Total Uses of Funds	**6,682.6**	9,607.1
Funds (cash and temporary cash investments) at December 31	**$ 2,213.7**	$ 2,139.9

Working capital components (excluding cash and temporary investments, debt maturing within one year, dividends payable and deferred income taxes)

	1985	1984
Increase (decrease) in net receivables	**$ (374.7)**	$ 5,113.6
Increase (decrease) in inventories	**(29.9)**	1,172.7
Increase (decrease) in other current assets	**(118.4)**	(286.4)
(Increase) decrease in accounts payable	**132.9**	(2,778.0)
(Increase) decrease in other current liabilities	**242.0**	(1,329.4)
Net change in working capital	**$ (148.1)**	$ 1,892.5

The notes on pages 22 through 29 are an integral part of the financial statements.

Notes to Consolidated Financial Statements

DOLLARS IN MILLIONS (except per share amounts)

(A) Summary of Major Accounting Policies

Consolidation

The consolidated financial statements include the accounts of AT&T and all its significant majority-owned subsidiaries other than the AT&T Credit Corporation, which is accounted for under the equity method. Investments in 20 to 50 percent-owned companies and joint ventures are also accounted for under the equity method. Other investments are recorded at cost.

Industry Segmentation

AT&T operates predominantly in a single industry segment, the information movement and management industry. This segment constitutes more than 90% of the Company's total operating revenues, operating income, and identifiable assets. AT&T is also engaged in other activities which, in the aggregate, are not material or separately reportable. Such activities include the furnishing of shareholder services such as stock transfer activities, and the distribution of computer equipment through retail outlets. The information movement and management industry encompasses all facets of information and communications technology, including the development and provision of devices which receive, send, or process information, the provision of facilities and services to move information, the provision of services which provide customer support in information management, and other aspects of providing networks of computers and communications facilities.

Plant and Equipment

Commencing in 1984, the Company's investment in plant and equipment is stated at cost excluding intercompany profits. The Company's rate-regulated plant assets acquired prior to 1984 are recorded at cost, including reasonable inter-company profits in accordance with regulated accounting practices. At the time of divestiture, the carrying value of these assets was significantly reduced from economic value in a rate-regulated environment to economic value in a competitive environment. These economic value reductions were recorded primarily as increases in the depreciation reserve and included amounts required for the future restructuring of the business. As such restructuring plans became final, amounts for such expenses have been reclassified to current and long-term liabilities.

Depreciation

Depreciation is calculated principally by using the group straight-line method over the useful lives of assets; however, factory facilities placed in service subsequent to December 31, 1979 are depreciated on an accelerated basis. When depreciable plant is retired, the amount at which such plant has been carried in plant in service is credited to plant and generally charged to accumulated depreciation.

Software Development Costs

Commencing in 1985, as a result of a new Financial Accounting Standards Board pronouncement, the Company changed its method of accounting for software development costs so that costs incurred in the research, design and development of software for sale or lease to others are charged to research and development expense until technological feasibility is established, after which remaining software production costs are capitalized and then amortized to product costs over the estimated period of sales. Previously, all such costs were charged as incurred to research and development. See also Note (C).

Access Charges

Access charges, the fees that the Company pays to Local Exchange Companies for access to local telephone networks, are recovered by the Company for the benefit of the Local Exchange Companies in charges to customers and are included in the Company's gross revenues. The charges to the Company for such fees are reported as reductions of revenue. It is expected that access charges will gradually be supplanted by end user charges which customers will pay directly to the Local Exchange Companies. At the time of such changes, the Company's gross revenues would be expected to be reduced by amounts generally comparable to the reduction in access charges.

Inventories

Raw materials, work in process, and completed goods inventories are stated at the lower of cost or market. Cost is principally determined on a first-in, first-out basis for raw materials and work in process and on an average cost basis for completed goods.

Retirement Plans

Substantially all costs are accrued over the active working lives of the employee work force. See also Note (F).

Income Taxes

Income tax expense includes the effects of timing differences between reported earnings and taxable earnings. These dif-

ferences arise when certain transactions are included in the financial statements in years different from those in which they are reported for income tax purposes. Investment tax credits are deferred and amortized as a reduction of income tax expense over the useful life of the applicable property.

(B) 1984 Divestiture and Other Factors Affecting Comparison of Financial Data

On January 1, 1984, a new AT&T came into being as a result of a Court-ordered division of the telecommunications business into Bell Operating Companies ("BOCs") owned by seven Regional Holding Companies ("RHCs") and AT&T. For AT&T, this divestiture meant giving up almost three-fourths of the Company's assets to the RHCs, while at the same time receiving the opportunity to enter all aspects of the information movement and management business (except electronic publishing for a seven year period), including entry into markets which were previously denied.

Due to the magnitude and nature of divestiture and the related accounting and organizational changes which occurred, AT&T's financial and operating results for 1985 and 1984 are not comparable to those of prior years; consequently, pre-divestiture data are not included in this year's Annual Report. However, copies of pre-divestiture financial statements which were filed previously with the Securities and Exchange Commission are available from the Company upon request without charge.

Results for 1985 and 1984 have been affected by Company reorganizations and by the adoption of uniform methods of classifying and presenting financial data in the Company's new operating environment. Amounts for 1984 have been reclassified to conform with 1985 classifications.

(C) Research and Development

AT&T invests significant resources in a broad program of basic research, applied research, and development activities. This work, which is principally performed by the Company's wholly-owned subsidiary, Bell Telephone Laboratories, Incorporated ("AT&T Bell Laboratories"), is done both to advance scientific knowledge and to develop new and improved products and processes. Research and development expenditures are charged to expense as incurred.

As described in Note (A), commencing in 1985 $160.9 of software production costs, previously recorded as research and development expenditures, were capitalized and recorded as other assets. During 1985 $41.9 of these costs were amortized as cost of products leaving a balance in other assets at December 31, 1985 of $119.0.

(D) Other Income-Net

In addition to income from sales of products, services, and rentals, the Company has income and expenses related to other sources as follows:

	1985	1984
Interest, royalties and dividends	**$260.2**	$478.9
Equity earnings from unconsolidated entities	**43.9**	19.9
Gain (loss) on sale of fixed assets	**(9.0)**	41.5
Miscellaneous-net	**(43.3)**	(15.8)
Total	**$251.8**	$524.5

(E) Interest Expense

Interest expense relates to the cost of short and long-term debt and interest incurred on other obligations and is net of interest amounts capitalized which were $96.7 and $74.7 in 1985 and 1984, respectively. Capitalized interest represents the estimated interest cost of funds used to finance construction projects. The amount of interest capitalized is added to the cost of the constructed assets.

(F) Provisions for Pensions and Death Benefits

The Company has pension plans covering substantially all management and non-management employees, for which the Company–not the employees–contributes toward the pension benefits. These contributions are made to trust funds, which are held for the sole benefit of employees. The Company's policy is to make contributions which are equal to the current year cost of the plans. The following data provide information on plan costs:

	1985	1984
Current year cost	**$ 657.1**	$1,043.4
Current year cost as a percent of salaries and wages	**5.7%**	9.0%

The current year cost is determined on a going concern basis by using the Aggregate Cost Method, which is one of the actuarial cost methods permitted by the Employee Retirement Income Security Act of 1974 ("ERISA"). Under this method, as under any other actuarial cost method, assumptions such as the rate of return on plan assets are necessary.

The assumed rates of return for computing the 1985 cost are 12½% for 1985, declining to a level of 5½% in 1998 and later years; these rates of return are equivalent to a level rate of return of approximately 6.7%. The 1984 cost was computed using assumed rates of return of 8% for 1984 that declined to a level of 5% by 1998, remaining at 5% thereafter; these rates of return are equivalent to a level rate of return of approximately 5.7%. The higher rates of return used in computing the 1985 cost reflect the favorable earnings of the plan assets in recent years. If the assumed rates of return were 1% lower, 1985 cost would have been $1,147.7 instead of $657.1.

In addition to rates of return on plan assets, assumptions are also made as to future compensation levels, retirement ages, employee turnover and mortality rates. Variances between actual and assumed data are amortized over the remaining employee service period and affect the level of the current year cost.

The reduction in pension cost from 1984 to 1985 is primarily due to the assumption of a higher rate of return on plan assets. The total effect of all changes in assumptions was to reduce 1985 pension cost by $357.1. Other factors, principally variances between actual and assumed experiences in computing the prior year's pension cost, reduced the 1985 pension cost by $68.7. Amendments to the plan increased 1985 pension cost by $39.5.

The following table shows the actuarial present value of accumulated plan benefits (essentially the portion of total pension benefits applicable to employee service to date) and the estimated market value of plan assets available to pay benefits:

	December 31, 1984(a)	January 1, 1984(b)
Actuarial present value of plan benefits:		
Vested	**$12,634.1**	$11,464.0
Non-Vested	**2,009.4**	1,997.3
Total	**$14,643.5**	$13,461.3
Actuarial present value of plan benefits including estimated effects of increases in compensation levels and plan amendments adopted after valuation date	**$15,921.6**	$14,517.1
Estimated market value of net assets available for plan benefits	**$18,682.3**	$16,951.9

Column (a) shows data as of the latest actuarial valuation date (December 31, 1984). Column (b) shows the data as of January 1, 1984, restated for a change in assumption in computing the column (a) data as discussed in the following paragraph. The value of net assets of $16,951.9 shown in column (b) differs from the $17,148.3 which was shown on an estimated basis in the 1984 Annual Report.

The actuarial present values of the accumulated plan benefits are based on the same assumed rate of return on plan assets as was used in determining the 1985 pension cost (6.7%). This rate is considered to more appropriately reflect the long-term rate of return on plan assets instead of the Pension Benefit Guaranty Corporation ("PBGC") rates that were used in prior years. If the assumed rates of return were 1% lower, the total amounts shown in the above table would have been $17,285.5 instead of $14,643.5 shown in column (a) and $15,711.6 instead of $13,461.3 as shown in column (b).

The additional disclosures of the actuarial present value of plan benefits including estimated increases in compensation levels and plan amendments adopted after valuation date ($15,921.6 in column (a) and $14,517.1 in column (b)) are made to better reflect the pension plan obligation on a going-concern basis.

The Company believes that misleading inferences concerning the plan's funding status may result from a comparison of the actuarial present value of accumulated plan benefits with the estimated market value of net assets available for plan benefits since the market value of these net assets will fluctuate.

(G) Postretirement Benefits

The Company's benefit plan for retirees includes health care benefits and life insurance coverage.

The health care benefits are provided through insurance company contracts. The Company recognizes the cost of providing health care benefits by expensing the annual insurance premiums, which amounted to $867.6 and $799.7 for 1985 and 1984, respectively. This cost, which is not separable between active and retired employees, included costs for approximately 338,000 active and 76,000 retired employees for 1985 and approximately 365,000 active and 70,000 retired employees for 1984. Additionally, under the terms of the Divestiture Plan of Reorganization, the Company pays a portion of the health care benefit costs of the divested BOCs' pre-divestiture retirees. Such costs are expensed as incurred and totaled $59.0 for 1985 and $92.0 for 1984.

The cost of providing life insurance benefits to retirees was $27.2 and $36.3 for 1985 and 1984, respectively. This cost was determined using the Aggregate Cost actuarial method.

(H) Income Taxes

The provision for income taxes, detailed in the following table, recognizes that revenue and expense items may affect financial statements and tax returns in different periods (timing differences):

	1985	1984
Current		
Federal	**$ 103.0**	$ (228.1)
State and local	**117.3**	14.5
Foreign	**21.9**	8.6
Deferred		
Federal	**743.2**	682.2
State and local	**109.0**	95.1
Foreign	**2.8**	–
Deferred investment tax credits–net*	**(107.6)**	9.2
Total	**$ 989.6**	$ 581.5

*Net of amortization of $299.6 in 1985 and $309.2 in 1984.

The current federal income tax expense was negative in 1984 due to research credits and a net operating loss for tax purposes which were carried back to prior years. All 1984 credits not usable as carrybacks in 1984 are estimated to be usable in the 1985 tax return. The general business credits generated in 1985 which are not expected to be usable in the 1985 tax return amount to approximately $300.0. These credits may be carried forward for 15 years under current tax law.

The 1985 deferred taxes include the tax effects of the following major timing differences which decreased the current tax provision: depreciation, $637.8; closing of facilities and special termination benefits, $234.3; a reversal of a reserve for refunds, $160.8; and capitalized software costs, $58.6; offset by sale-leaseback transactions, $73.1, and other timing differences, $163.4. The major timing differences affecting 1984 deferred taxes were depreciation, sales-type leases, and closing of facilities and special termination benefits.

The Company's effective income tax rate (i.e., provision for income taxes as a percent of income before income taxes) is lower than the statutory federal income tax rate of 46% as shown below:

	1985	1984
Statutory federal income tax rate	**46.0%**	46.0%
Amortization of investment tax credits	**(11.8)**	(15.8)
State and local income taxes, net of federal income tax effect	**4.8**	3.1
Research credits	**(1.5)**	(3.2)
Other differences	**1.4**	(.3)
Effective income tax rate	**38.9%**	29.8%

(I) Inventories

The Company maintains stocks of equipment and materials for sale to customers or for use in the business, as follows:

	At December 31, 1985	1984
Completed goods (new and used products held for sale, lease or maintenance)	**$2,287.0**	$1,875.8
In process	**1,727.0**	1,999.4
Raw materials and supplies	**745.3**	914.0
Total	**$4,759.3**	$4,789.2

(J) Property, Plant and Equipment

The Company's property, plant and equipment accounts reflect assets used in manufacturing, selling, renting, servicing, research, and administrative operations. Both owned assets and those acquired through capital leases are included in the following table, which shows the major categories of property, plant and equipment:

	At December 31, 1985	1984
Land and improvements	**$ 480.0**	$ 452.6
Buildings and improvements	**5,812.5**	5,648.8
Machinery and electronic equipment	**29,627.0**	30,046.7
Transportation equipment, furniture, tools and other	**2,742.8**	2,359.7
Total property, plant, and equipment	**38,662.3**	38,507.8
Less: Accumulated depreciation	**16,549.4**	17,492.8
Property, plant and equipment–net	**$22,112.9**	$21,015.0

(K) Leases

As Lessee

The Company leases land, buildings and equipment through contracts that expire in various years. Items leased on a long-term basis or otherwise qualifying under the accounting rules as a capital lease are included in the Company's asset accounts and a corresponding liability is booked for the future minimum lease payments. Items not qualifying as a capital lease are accounted for as an operating lease, i.e., the annual rental is recorded as an operating expense of that year. The Company's future minimum lease payments under capital and noncancelable operating leases at December 31, 1985 are as follows:

	Capital Leases	Operating Leases
Minimum lease payments for year ending December 31,		
1986	$195.5	$ 589.1
1987	164.5	494.5
1988	97.9	349.9
1989	52.8	214.6
1990	47.8	175.0
Later years	273.0	814.0
Total minimum lease payments	$831.5	$2,637.1
Less: Estimated executory cost on capital leases	20.2	
Imputed interest on capital leases	286.6	
Present value of net minimum capital lease payments	$524.7	

Rental expense for operating leases was $1,041.3 in 1985 and $855.9 in 1984.

As Lessor

The Company leases its products to others under sales-type leases (essentially a sale, which under accounting rules requires the lessor to reduce the balance in its inventory account and record a receivable for the future rentals). The Company's net investment in sales-type leases at December 31, 1984 was $521.6, which was acquired by AT&T-Credit in 1985. Also see Note (L).

The Company also leases equipment to others on an operating lease basis; the majority of these leases are cancelable. The net investment in such equipment was as follows:

	At December 31, 1985	1984
Machinery and equipment	**$5,694.9**	$8,831.3
Less: Accumulated depreciation	**2,968.5**	5,784.6
Net investment	**$2,726.4**	$3,046.7

The minimum rentals to be received on operating leases are as follows:

1986	$ 201.5
1987	103.5
1988	47.4
1989	11.4
1990	.2
Later years	–
Total	$ 364.0

(L) Equity Investment in Finance Subsidiary

To enhance the marketability of the Company's products, AT&T Credit Corporation (AT&T-Credit), a wholly-owned unconsolidated subsidiary of AT&T, commenced operations on January 1, 1985. AT&T-Credit provides financing to customers through leasing and installment sales programs, and it purchases from AT&T's subsidiaries the rights to receivables under long-term service agreements recorded as sales-type capital leases.

The Company's investment in AT&T-Credit, which amounted to $349.9 as of December 31, 1985, is accounted for under the equity method. AT&T-Credit's earnings of $14.3 for 1985 are included in other income in AT&T's consolidated statement of income. During 1985, the Company sold to AT&T-Credit $920.7 million in current and long-term sales-type lease receivables–net of unearned interest income, for which AT&T-Credit has full recourse against the Company. Following is a summarized balance sheet for AT&T-Credit at December 31, 1985.

Net investment in receivables purchased from AT&T	$673.3
Other assets	37.1
Total assets	$710.4
Notes and other debt currently maturing	$309.3*
Other current liabilities	73.8
Long-term debt	235.3**
Shareowner's equity	92.0
Total liabilities and shareowner's equity	$710.4

* Includes $125.0 due AT&T.
**Includes $125.0 due AT&T.

(M) Other Investments at Equity

The Company makes major investments in other companies and joint ventures to assure sources of supply and production, to develop worldwide marketing channels and to further the Company's overall business interests. As of December 31, 1985, the Company's major equity investments in addition to the investment in AT&T-Credit described in Note (L) above are:

Ing. C. Olivetti & C., S.p.A. ("Olivetti")–25% of voting shares owned, to market the Company's computer products through this international manufacturer and marketer of automated office equipment and communication products. The Company's investment at equity was $275.8 and $252.5 at December 31, 1985 and 1984, respectively. The market value of the Company's investment in Olivetti as measured by the closing price on the Milan, Italy stock exchange on December 31, 1985 amounted to $523.1.

Joint Venture with N.V. Philips–50% of voting shares owned, to market the 5ESS switch and transmission products in Europe, the Middle East and South America. The Company's investment at equity was $99.6 and $86.1 at December 31, 1985 and 1984, respectively.

Joint Venture with Gold Star Semiconductor–44% of voting shares owned, to manufacture the 5ESS switch and other switching products for sale in Korea. The Company's investment at equity was $18.1 and $19.7 at December 31, 1985 and 1984, respectively.

Dividends received from equity investment entities were $21.4 (including $7.3 from AT&T-Credit) in 1985 and $2.7 in 1984. The Company's cumulative equity investment in undistributed earnings of investees (including $7.0 pertaining to AT&T-Credit) was $58.8 at December 31, 1985. See also Note (D).

(N) Debt Maturing Within One Year

To obtain funds for operating needs, the Company borrows funds through short-term financing arrangements. Such borrowings and the portion of long-term obligations requiring repayment in the next calendar year are as follows:

	At December 31, 1985	1984
Notes Payable:		
Commercial paper	**$ 150.1**	$172.2
Other notes	**2.1**	2.2
Current portion of long-term lease obligations	**146.5**	112.2
Long-term debt maturing within one year	**1,138.7**	563.5
Total	**$1,437.4**	$850.1

Through February 10, 1986, the Company has announced plans to call two issues of long-term debt: (a) $600.0 of 13¼% notes due in 1991 and (b) $400.0 of 14¼% Eurobonds due in 1989. This debt has been reclassified from long-term debt and is included in $1,138.7 long-term debt maturing within one year shown above. During 1985, the Company called $300.0 of debt of The Pacific Telephone and Telegraph Company which was assumed by the Company at divestiture and retired $250.0 of the Company's debentures that became due in 1985.

(O) Long-Term Obligations

To obtain funds for major business expansions and other corporate needs, the Company issues long-term debt (notes and debentures) when appropriate in light of interest rates and alternate ways of obtaining funds.

The long-term debt outstanding as of December 31, 1985 is shown below by the years of maturity and interest rates:

Maturities	2⅞% to 6⅞%	7% to 8⅞%	9% to 12⅞%	Total
1987	$ 307.0	$ 15.0	$ 7.5	$ 329.5
1988	7.0	15.0	7.5	29.5
1989	7.0	15.0	7.5	29.5
1990	257.0	15.0	682.5	954.5
1991–2000	2,144.0	1,242.1	337.5	3,723.6
2001–2010	250.0	1,690.0	–	1,940.0
2011–2019	–	300.0	–	300.0
Total long-term debt	$2,972.0	$3,292.1	$1,042.5	$7,306.6
Long-term lease obligations				378.2
Other				31.8
Unamortized discount-net				(18.8)
Total long-term obligations				$7,697.8

None of the long-term debt above is secured by mortgage or pledge of the Company's assets, nor can it be converted to common or preferred shares. The trust indentures covering the long-term debt do not place any restriction on payment of dividends.

(P) Stock Options and Employee Incentive Plans

To maximize the long-term value of the shareowners' investment through successful management of the Company, the AT&T Stock Option Plan–approved by the shareowners–offers to selected key managers rewards whose value is determined entirely by the price of AT&T stock in the marketplace. Under the plan, a maximum of 20,000,000 shares are available for grant of options.

The Compensation Committee of the Board administers the plan, which provides for granting options for the future purchase of the Company's common shares at the market price on the day of the grant. An option becomes exercisable one year after date of grant. The Committee may also grant Stock Appreciation Rights ("SARs") to certain holders of options. The SARs offer the optionees an alternative of electing not to exercise the related stock option, but to receive instead an amount in cash which equals the difference between the option price and the market price of the stock on the date of exercising the SAR.

The plan shall expire December 21, 1993 unless previously terminated. The table below shows the option transactions during 1985:

	Number of Shares Currently Under Option	Available for Option
Balance at January 1, 1985	1,508,372	18,491,628
Options granted	2,036,350	(2,036,350)
Options exercised*	(80,670)	–
Options forfeited	(168,516)	168,516
Balance at December 31,1985**	3,295,536	16,623,794
Exercisable at December 31, 1985	1,415,122	

* Average option price was $17.90
**Average option price was $18.80

During 1985, SARs were granted for 260,600 shares for an average exercise price of $19.38, and no SARs were exercised. As of December 31, 1985, 323,463 SARs remained unexercised, of which 62,863 SARs were exercisable as of December 31, 1985.

The Company also has the AT&T Long Term Incentive Plan, approved by the shareowners, under which units equal to the value of one common share are awarded to selected Senior Managers. Common shares or cash, or a combination thereof may be issued for these units upon the achievement of specified financial and management objectives. During 1985, 404,527 units were awarded with an average value of $19.31 per unit.

(Q) Preferred Shares

The Company has 100,000,000 authorized shares of preferred stock at $1 par value. The outstanding issues are as follows:

$3.64 preferred shares having a $50 stated value–9,100,000 shares are outstanding. These shares may be redeemed by the Company at a premium of $2.39 per share on or before April 30, 1986 and at a diminishing premium thereafter.

$3.74 preferred shares having a $50 stated value–9,400,000 shares are outstanding. These shares may be redeemed by the Company at a premium of $2.46 per share on or before January 31, 1987 and at a diminishing premium thereafter.

$77.50 preferred shares having a $1,000 stated value–512,500 shares are outstanding. These shares may be redeemed by the Company at a premium of $46.50 per share on or before January 31, 1987 and at a diminishing premium thereafter.

The $3.64 and $3.74 issues described above contain a requirement for sinking fund redemption each year of 3% of the shares without premium, and an additional 3% may also be redeemed at the Company's option. During each of the years 1985 and 1984, the Company redeemed 300,000 of the $3.64 preferred shares and 300,000 of the $3.74 preferred shares per the sinking fund requirements. For the $77.50 preferred shares, on February 1 of each year through 1992 the Company must redeem 12,500 of these shares through a sinking fund at stated value; thereafter the requirement is 18,750 shares each year; an equal number may be redeemed at the Company's option each year. During each of the years 1985 and 1984, the Company redeemed 12,500 of these shares.

The total sinking fund requirements for all series of preferred shares subject to mandatory redemption are $42.5 per year for 1986 through 1990. These sinking fund requirements are cumulative; that is, should redemption amounts not be set aside in full because the net assets of the Company are insufficient, or for any other reason, such amounts must be set aside, without interest, before any common share dividends are paid or declared, or any common shares are purchased or redeemed.

All preferred shares rank prior to the common shares both as to dividends and on liquidation but have no general voting rights. However, if dividends on any series of preferred shares are in default in an amount equal to six quarterly dividends, the number of directors of the Company will be increased by two and the holders of all preferred shares will have the exclusive right, voting separately as a class, to elect such two additional directors so long as such default continues.

Accounting for the Effects of Inflation (Unaudited)

High rates of inflation in the years prior to 1979 drew increased attention to the need to assess both the impact of inflation on business and the results of management's efforts in coping with it. The Financial Accounting Standards Board ("FASB"), believing that additional experience should be gained and experimentation undertaken with respect to reporting the effects of inflation, issued Statement of Financial Accounting Standard No. 33 ("Statement No. 33") in 1979. This Statement, as amended by subsequent FASB pronouncements, requires disclosure of supplementary data to reflect the effects of general inflation (constant dollar) and the effects of changes in specific prices (current cost). Inflation continues to erode the purchasing power of the dollar, although the rate of inflation has slowed significantly in recent years. The data presented in Tables A and B on page 31 have been computed in accordance with Statement 33, as amended. The Company believes that this information should be used with care because it neither completely nor accurately portrays inflation's effects.

In the "current cost" method of estimating the effects of inflation, financial statement elements are restated to reflect the changes in specific prices of fixed assets and of the goods and services that the Company purchases or manufactures. These changes in specific prices affect earnings and stockholders equity through changes in inventory values, depreciation, and cost of sales. The Company's current cost estimates are based primarily on internally-developed indices reflecting changes in labor and material costs, and on appraised valuations of property, published price indices and current suppliers' prices.

Table A–presents "income from continuing operations" as if depreciation of assets had been based on current cost asset amounts expressed in dollars of constant purchasing power. In computing "income from continuing operations" only depreciation expense and cost of sales have been adjusted to show the effects of inflation. Because most other operating expense items are current year transactions, they are already recorded in dollars of approximately current purchasing power.

As can be seen from the current cost adjustments in Table A, the Company's inflation-adjusted net income from continuing operations is significantly lower than the income reported in the historical cost financial statements. This indicates that inflation has had a significant impact on the replacement cost of the Company's inventories and property, plant and equipment, with a resulting theoretical increase in costs and expenses.

In accordance with requirements of Statement No. 33, no adjustments have been made to reflect any effects of inflation on provision for income taxes. The effective income tax rate (provision for income taxes as a percent of income before income taxes) for the historical data in Column (a) of Table A is 38.9 percent. This rate reflecting adjustments for inflation would be 71.6 percent for Column (b) of Table A. While the income taxes used in these computations include investment tax credits and tax deferrals relating to accelerated depreciation, the effects of inflation on effective tax rates also would be increased dramatically, even though in lower percentages, if these tax benefits were excluded. These tax benefits were intended by Congress to provide for funds for investment in other capital assets in order to increase productivity and employment.

The reader is cautioned that inflation adjusted data do not represent the financial consequences of actual operations of the Company. The Company does not plan to replace or dispose of its plant on any large scale. Furthermore, the environment of inflation is a condition which affects all business entities, rather than relating specifically to the Company's operations.

Table B presents selected financial data adjusted for the effects of changing prices. Statement No. 33 requires that such information be presented in a five-year summary. However, for the reasons described in Note (B) to the financial statements, data for the pre-divestiture years are not included in Table B. Amounts shown as "Net assets at year end" ($27,280.0 for 1985 and $25,312.9 for 1984) equal common shareowners' equity at the end of the respective years, as adjusted for changes in specific prices by the difference between plant and inventories at historic cost and plant and inventories at current cost. Statement No. 33 also requires that the data shown in Table B be restated into the average purchasing power of the dollar during 1985. The calculations for these restatements (except market price per common share) have been made by applying the average Consumer Price Index for all Urban Consumers (CPI-U) for 1985 to the 1984 data. The calculations for market price per common share have been made by applying the average CPI-U for 1985 to the data for the years 1985 and 1984.

Since the actual market price for 1985 is stated in year end dollars which have a lower purchasing power than the average 1985 dollar, the effect of the calculation for 1985 is to decrease the year end market price per common share from the actual quoted amount. No adjustments have been made to the historical cost information, which is presented for comparison purposes only.

Tables A and B contain an item identified as "purchasing power gain on net monetary items." During periods of inflation, lenders of money experience a loss due to the fact that amounts owed to them will be repaid in dollars having less purchasing power than the dollars originally lent; it is in anticipation of such loss that interest rates are high during inflationary times. Conversely, to the extent that lenders are losing purchasing power, borrowers are benefiting. In 1985, the Company experienced a $352.3 purchasing power gain on net monetary items, indicating that total liabilities requiring a future fixed cash settlement amount exceeded like assets. It should be noted that this is a hypothetical gain, which is excluded from income.

Table A Supplementary Financial Data
Adjusted for the Effects of Inflation and Changing Prices
Year ended December 31, 1985

Dollars in Millions	As Reported in the Historical Cost Financial Statements (a)	Adjusted for Changes in Specific Prices (Current Cost) (b)
Sales and revenues	$34,909.5	$34,909.5
Total operating costs and expenses excluding depreciation expense	28,691.8	28,655.1
Depreciation expense	3,231.6	4,432.7
Provision for income taxes	989.6	989.6
Other expenses–net	439.7	439.7
Income from continuing operations	$ 1,556.8	$ 392.4
Property, plant and equipment–net at year end	$22,112.9	$35,024.7
Inventories at year end	4,759.3	4,934.5
Purchasing power gain on net monetary items		352.3
Increase in specific prices (current cost) of inventories, property, plant and equipment held during the year		3,227.7

Table B Supplementary Two-Year Comparison of Selected Financial Data

Dollars in Millions (except per share amounts)	1985	1984
Operating revenues in average 1985 dollars	**$34,909.5**	$34,371.6
Historical cost information:		
Income from continuing operations	**$ 1,556.8**	$ 1,369.9
Income from continuing operations per common share[1]	**1.37**	1.25
Net assets at year end	**14,633.3**	13,762.9
Historical cost information adjusted for changes in specific prices (average 1985 dollars):		
Income from continuing operations	**$ 392.4**	$ 601.9
Income from continuing operations per common share[1]	**.27**	.48
Increase in current cost of inventories and property, plant and equipment held during the year net of general inflation	**1,416.7**	1,408.1
Net assets at year end	**27,280.0**	25,312.9
Other information:		
Purchasing power gain on net monetary items	**$ 352.3**	$ 287.6
Cash dividends declared per common share:		
At historical cost	**$ 1.20**	$ 1.20
In average 1985 dollars	**1.20**	1.24
Market price per common share at year end:		
At historical cost[2]	**$ 25.00**	$ 19.50
In average 1985 dollars	**24.60**	19.92
Average CPI-U	**322.2**	311.1

[1]Income from continuing operations per common share is after preferred dividend requirements.
[2]Using Composite Tape closing price.

Accounting for the Effects of Inflation (Unaudited)

High rates of inflation in the years prior to 1979 drew increased attention to the need to assess both the impact of inflation on business and the results of management's efforts in coping with it. The Financial Accounting Standards Board ("FASB"), believing that additional experience should be gained and experimentation undertaken with respect to reporting the effects of inflation, issued Statement of Financial Accounting Standard No. 33 ("Statement No. 33") in 1979. This Statement, as amended by subsequent FASB pronouncements, requires disclosure of supplementary data to reflect the effects of general inflation (constant dollar) and the effects of changes in specific prices (current cost). Inflation continues to erode the purchasing power of the dollar, although the rate of inflation has slowed significantly in recent years. The data presented in Tables A and B on page 31 have been computed in accordance with Statement 33, as amended. The Company believes that this information should be used with care because it neither completely nor accurately portrays inflation's effects.

In the "current cost" method of estimating the effects of inflation, financial statement elements are restated to reflect the changes in specific prices of fixed assets and of the goods and services that the Company purchases or manufactures. These changes in specific prices affect earnings and stockholders equity through changes in inventory values, depreciation, and cost of sales. The Company's current cost estimates are based primarily on internally-developed indices reflecting changes in labor and material costs, and on appraised valuations of property, published price indices and current suppliers' prices.

Table A–presents "income from continuing operations" as if depreciation of assets had been based on current cost asset amounts expressed in dollars of constant purchasing power. In computing "income from continuing operations" only depreciation expense and cost of sales have been adjusted to show the effects of inflation. Because most other operating expense items are current year transactions, they are already recorded in dollars of approximately current purchasing power.

As can be seen from the current cost adjustments in Table A, the Company's inflation-adjusted net income from continuing operations is significantly lower than the income reported in the historical cost financial statements. This indicates that inflation has had a significant impact on the replacement cost of the Company's inventories and property, plant and equipment, with a resulting theoretical increase in costs and expenses.

In accordance with requirements of Statement No. 33, no adjustments have been made to reflect any effects of inflation on provision for income taxes. The effective income tax rate (provision for income taxes as a percent of income before income taxes) for the historical data in Column (a) of Table A is 38.9 percent. This rate reflecting adjustments for inflation would be 71.6 percent for Column (b) of Table A. While the income taxes used in these computations include investment tax credits and tax deferrals relating to accelerated depreciation, the effects of inflation on effective tax rates also would be increased dramatically, even though in lower percentages, if these tax benefits were excluded. These tax benefits were intended by Congress to provide for funds for investment in other capital assets in order to increase productivity and employment.

The reader is cautioned that inflation adjusted data do not represent the financial consequences of actual operations of the Company. The Company does not plan to replace or dispose of its plant on any large scale. Furthermore, the environment of inflation is a condition which affects all business entities, rather than relating specifically to the Company's operations.

Table B presents selected financial data adjusted for the effects of changing prices. Statement No. 33 requires that such information be presented in a five-year summary. However, for the reasons described in Note (B) to the financial statements, data for the pre-divestiture years are not included in Table B. Amounts shown as "Net assets at year end" ($27,280.0 for 1985 and $25,312.9 for 1984) equal common shareowners' equity at the end of the respective years, as adjusted for changes in specific prices by the difference between plant and inventories at historic cost and plant and inventories at current cost. Statement No. 33 also requires that the data shown in Table B be restated into the average purchasing power of the dollar during 1985. The calculations for these restatements (except market price per common share) have been made by applying the average Consumer Price Index for all Urban Consumers (CPI-U) for 1985 to the 1984 data. The calculations for market price per common share have been made by applying the average CPI-U for 1985 to the data for the years 1985 and 1984.

Since the actual market price for 1985 is stated in year end dollars which have a lower purchasing power than the average 1985 dollar, the effect of the calculation for 1985 is to decrease the year end market price per common share from the actual quoted amount. No adjustments have been made to the historical cost information, which is presented for comparison purposes only.

Tables A and B contain an item identified as "purchasing power gain on net monetary items." During periods of inflation, lenders of money experience a loss due to the fact that amounts owed to them will be repaid in dollars having less purchasing power than the dollars originally lent; it is in anticipation of such loss that interest rates are high during inflationary times. Conversely, to the extent that lenders are losing purchasing power, borrowers are benefiting. In 1985, the Company experienced a $352.3 purchasing power gain on net monetary items, indicating that total liabilities requiring a future fixed cash settlement amount exceeded like assets. It should be noted that this is a hypothetical gain, which is excluded from income.

Table A Supplementary Financial Data

Adjusted for the Effects of Inflation and Changing Prices
Year ended December 31, 1985

Dollars in Millions	As Reported in the Historical Cost Financial Statements (a)	Adjusted for Changes in Specific Prices (Current Cost) (b)
Sales and revenues	$34,909.5	$34,909.5
Total operating costs and expenses excluding depreciation expense	28,691.8	28,655.1
Depreciation expense	3,231.6	4,432.7
Provision for income taxes	989.6	989.6
Other expenses–net	439.7	439.7
Income from continuing operations	$ 1,556.8	$ 392.4
Property, plant and equipment–net at year end	$22,112.9	$35,024.7
Inventories at year end	4,759.3	4,934.5
Purchasing power gain on net monetary items		352.3
Increase in specific prices (current cost) of inventories, property, plant and equipment held during the year		3,227.7

Table B Supplementary Two-Year Comparison of Selected Financial Data

Dollars in Millions (except per share amounts)	**1985**	1984
Operating revenues in average 1985 dollars	**$34,909.5**	$34,371.6
Historical cost information:		
Income from continuing operations	**$ 1,556.8**	$ 1,369.9
Income from continuing operations per common share[1]	**1.37**	1.25
Net assets at year end	**14,633.3**	13,762.9
Historical cost information adjusted for changes in specific prices (average 1985 dollars):		
Income from continuing operations	**$ 392.4**	$ 601.9
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Net assets at year end	**27,280.0**	25,312.9
Other information:		
Purchasing power gain on net monetary items	**$ 352.3**	$ 287.6
Cash dividends declared per common share:		
At historical cost	**$ 1.20**	$ 1.20
In average 1985 dollars	**1.20**	1.24
Market price per common share at year end:		
At historical cost[2]	**$ 25.00**	$ 19.50
In average 1985 dollars	**24.60**	19.92
Average CPI-U	**322.2**	311.1

[1]Income from continuing operations per common share is after preferred dividend requirements.

[2]Using Composite Tape closing price.

AT&T and Subsidiaries

Summary of Financial Data

On January 1, 1984, AT&T was required by Court order to divest those parts of the Bell System operating telephone companies that provided local exchange and exchange access services and printed directory advertising. As a consequence of the divestiture, the financial results of the pre-divestiture years are not comparable to those of 1985 and 1984 and are not included below. Also see Note (B) to the financial statements.

Dollars in Millions (except per share amounts)	1985	1984
For the year:		
Total operating revenues	**$ 34,910**	$ 33,188
Total operating costs and expenses	**31,923**	30,893
Net income	**1,557**	1,370
Dividends on preferred shares	**110**	112
Income applicable to common shares	**1,447**	1,258
Earnings per common share	**1.37**	1.25
Dividends declared per common share	**1.20**	1.20
At end of year:		
Total assets	**$ 40,463**	$ 39,827
Long-term debt including capital leases	**7,698**	8,718
Preferred shares subject to mandatory redemption	**1,457**	1,494
Other statistics:		
Operating income as a percent of operating revenues	**8.6%**	6.9%
Return on average common equity	**10.1%**	9.5%
Current ratio at year end	**1.5**	1.5
Debt ratio at year end	**36.2%**	38.5%
Capital expenditures	**$ 4,580**	$ 3,611
Employees at year end	**337,600**	365,200

Market and Dividend Data

The stock prices shown in the accompanying table are of AT&T common stock which is primarily traded on the New York Stock Exchange, and also on the Philadelphia, Boston, Midwest, and Pacific exchanges as well as in off-board markets. The prices are obtained from the Composite Tape encompassing the trading in all of the above markets. Dividend data for the last two fiscal years are also shown in the accompanying table. The payment of subsequent dividends by the Company will depend upon the earnings and financial requirements of the Company and other factors. As of December 31, 1985, there were 2,927,067 holders of record of the common stock, a decrease of approximately 270,000 from December 31, 1984, which was principally due to the shareholders' Stock-Sale Program during the fourth Quarter of 1985. The Company also has preferred shares outstanding which rank prior to the common shares as to dividend. Details of the common stockholders' equity and preferred shares can be found in Notes (R) and (Q), respectively, to the financial statements.

Calendar	Quarter	Market Price High	Market Price Low	Dividends Declared
1985	**1st**	**$22⅛**	**$19**	**$.30**
	2nd	**24⅝**	**20⅜**	**.30**
	3rd	**24¼**	**20**	**.30**
	4th	**25⅜**	**19⅞**	**.30**
1984	1st	$19¾	$15	$.30
	2nd	17⅜	14⅞	.30
	3rd	20¼	16⅝	.30
	4th	20	17¾	.30

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Chairman,
AT&T Information Systems

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Senior Vice President
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Senior Vice President
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Senior Vice President
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Group Vice President
Corporate Operations
Planning and Development

*Frank S. Vigilante
Group Vice President
Data Processing and
Corporate Telecommunications

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Corporate Vice President
and Secretary

C. Perry Colwell
Corporate Vice President
and Controller

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Corporate Vice President
and Treasurer

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William A. Hightower
President and
Chief Executive Officer

Actuarial Sciences Associates, Inc.

Michael J. Gulotta
President and Chief Actuary

**Retiring effective February 13, 1986

*Effective January 1, 1986

International Activities, Alliances and Joint Ventures

AT&T and Philips Telecommunications (APT) A joint venture with the N.V. Philips Company of the Netherlands to manufacture and market network and transmission systems in Europe and elsewhere. Its flagship product is the 5ESS/PRX switch.

Olivetti AT&T purchased an equity interest in Ing. C. Olivetti & C., S.p.A. of Italy in 1984. The companies work together on the development and marketing of office automation products. Olivetti currently supplies AT&T's PC 6300 family of computers while handling–primarily in Europe–the AT&T 3B computer family, the AT&T System 75 PBX, AT&T voice and data terminals and related products.

UNIX Europe A London-based, wholly owned unit formed to market and license the UNIX System V operating system throughout Europe.

AT&T Microelectrónica España This joint venture with Compania Telefónica Nacional de España, the Spanish telephone company, will produce custom integrated circuits for the European market.

Gold Star Semiconductor A joint venture with the Lucky-Goldstar Group of the Republic of Korea for the manufacture of switching machines and for the distribution of the AT&T 3B family of computers in Korea.

Gold Star Fiber Optic Another joint venture with the Lucky-Goldstar Group for manufacturing fiber optic cable for the Korean market.

AT&T Taiwan Telecommunications Inc. This four-way venture among AT&T, the Directorate General of Telecommunications of Taiwan, the Bank of Communications and the Yao-Hua Glass Company will manufacture the 5ESS switch in Taiwan.

Western Electric Saudi Arabia This joint venture with A.S. Bugshan Bros. provides installation, operation and maintenance services for telecommunications operations in Saudi Arabia.

UNIX Pacific A wholly owned, Tokyo-based unit formed as a Far East equivalent of UNIX Europe for marketing and licensing UNIX System V in Asia.

Overseas Manufacturing AT&T has purchased the Honeywell Corporation's Synertek operation, which includes three overseas facilities for the design and future manufacture of electronic components. Now operating under the name *AT&T Microelectronics*, these facilities are located in Singapore, Thailand and West Germany. Also located in Singapore, *AT&T Consumer Products Private Limited* manufactures telephone sets. *AT&T International–Ireland* has four sites in the Republic of Ireland, all involved in the manufacture of transmission systems.

AT&T
The right choice.

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